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Investment Income and Expenses

For use in preparing
1990 **Returns**

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Important Changes for 1990

Education Savings Bond Program. Beginning in 1990, you may be able to exclude from income interest on qualified U.S. Savings Bonds that you redeem if you pay for qualified higher educational expenses. Qualified higher educational expenses are those you pay for tuition and required fees at an eligible educational institution (college or eligible vocational school) for you, your spouse, or your dependent. A "qualified U.S. Savings Bond" is a Series EE savings bond that is issued after December 31, 1989, to an individual 24 years of age or older. See *Education Savings Bond Program* under *Interest Income.*

New form to report like-kind exchanges. Use new Form 8824, *Like-Kind Exchanges,* to report the exchange of business or investment like-kind property. Also use Form 8824 to report nonrecognition of gain from conflict-of-interest sales.

Investment interest deduction. For 1990, you may claim a deduction of up to the amount of your net investment income, plus 10% of any excess investment interest over your net investment income, but not more than your net investment income plus $1,000 ($500 if married and filing separately).

Important Reminders

Child's income reported on parent's return. You may choose to include your child's dividend and interest income on your tax return if certain requirements are met. If you make this choice, your child is not required to file a return.

Allocated expenses of mutual funds. Allocated expenses of publicly-offered mutual funds are not subject to the 2% of adjusted gross income limit. "Publicly-offered" mutual funds are funds that are usually traded on an established securities market. Contact your mutual fund if you are not sure if your fund qualifies as publicly offered.

Reporting tax-exempt interest. You must show on your tax return the amount of any tax-exempt interest you received or accrued during the tax year. This is an information-reporting requirement and does not convert tax-exempt interest to taxable interest. For more information, see *How to Report Interest Income.*

Dividends received in January. Any dividend declared by a regulated investment company (mutual fund) or real estate investment trust (REIT) in October, November, or December and payable to you in such a month, but actually paid during January of the following calendar year, is treated as paid to you in the earlier year.

Stripped tax-exempt bonds. If you purchase or sell after June 10, 1987, a stripped tax-exempt bond or coupon, part of the original issue discount on the stripped bond or coupon may be taxable.

Amortizable bond premium. For taxable bonds acquired after 1987, the amount of any bond premium is allocated and used to reduce interest income on the bond. You must adjust the basis of the bond by the amount of the allocated premium used to reduce the interest income.

Capital loss carryover. Your allowable capital loss deduction is limited to the smaller of your total net capital loss, or $3,000 ($1,500 if married filing separate return). To determine your capital loss carryover, subtract from your capital loss the lesser of:

1) Your allowable capital loss deduction for the year, or
2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions exceed your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Holding period. The holding period for a long-term gain or loss is more than one year. The holding period for a short-term gain or loss is one year or less.

Introduction

This publication provides information on the tax treatment of investment income and expenses.

This publication explains what investment income is taxable, and what investment expenses are deductible. It explains when and how to show these items on your tax return. It also explains how to determine and report gains and losses on the disposition of investment property, and provides information on property trades and tax shelters.

There is a glossary at the end of this publication which defines many of the terms used.

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Investment income generally includes such items as interest, dividends, capital gains, and other types of distributions.

Investment expenses include such items as interest paid or incurred to acquire investment property and expenses to manage or collect income from investment property.

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676) or write the IRS Forms Distribution Center for your area as shown in the income tax package.

Investment Income

This part explains which types of investment income are taxable and which are not taxable. It includes information on interest income, dividends and other corporate distributions, REMICs, S corporations, and investment clubs.

As an important part of your records, you should keep a list showing sources and amounts of investment income that you receive during the year.

General Information

A few items of general interest are covered here.

Tax on investment income of a child under age 14. If a child is under age 14 at the end of the year and has more than $1,000 of investment income (such as taxable interest and dividends), part of his or her investment income may be taxed at the parent's tax rate if either parent is alive at the end of the year. If these requirements are met, **Form 8615,** *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,000,* must be completed and attached to the child's tax return. If these requirements are not met, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. **Form 8814,** *Parent's Election To Report Child's Interest and Dividends,* is used for this purpose.

For more information about the tax on investment income of children and the parent's election, see Publication 929, *Tax Rules for Children and Dependents.*

Beneficiary of an estate or trust. Interest, dividends, or other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.—1990,* from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the items on your Form 1040.

Social security number. You must give your name and social security number to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest and dividends.

Married taxpayers. If you are married and the funds in a joint account belong to you, you should give your social security number to the payer of the interest or dividends. If the funds in the account belong to both you and your spouse, you may give either your number or your spouse's number, as long as the number you provide corresponds with the name listed on the account.

Parent and child. If you own an insurance policy on the life of your dependent child, or own stock certificates or savings accounts jointly with your child, you should give your name and social security number to the payer of the interest or dividends. If your dependent child actually owns the funds in the account, you should give your child's name and social security number to the payer of the interest or dividends. You should furnish your child's social security number if your child actually owns the stock, but it is recorded in your name as custodian for the child and dividend checks are paid in the same way.

Penalty for failure to supply social security number. You will be subject to a penalty if you fail, when required, to:

1) Include your social security number on any return, statement, or other document,
2) Give your social security number to another person who is required to include it on any return, statement, or other document, or
3) Include the social security number of another person, including your dependent's, on any return, statement, or other document.

The penalty is $50 for each failure up to a maximum penalty of $100,000 for any calendar year.

In certain cases, you will not be subject to this penalty if you can show that your failure to provide this number was due to a reasonable cause and not to willful neglect.

If you fail to supply a social security number, you may also be subject to backup withholding.

Backup withholding. Payments you receive may be subject to backup withholding. Under backup withholding, the bank, broker, or other payer that pays you interest, original issue discount (OID), dividends, cash patronage dividends, or royalties must withhold, as income tax, 20% of the amount you are paid if:

1) You do not give the payer your identification number (either a social security number or an employer identification number) in the required manner,
2) The Internal Revenue Service (IRS) notifies the payer that you gave it an incorrect identification number,
3) You are required, but fail, to certify that you are not subject to backup withholding, or
4) The IRS notifies the payer that you are subject to backup withholding on interest or dividends because you have underreported interest or dividends on your income tax return. The IRS will do this only after it has mailed you four notices about the underreporting over a 120-day period.

You will be considered to have underreported your interest and dividends if the IRS has determined for a tax year that—

1) You failed to include any part of a reportable interest or dividend payment required to be shown on your return, or
2) You were required to file a return and to include a reportable interest or dividend payment on that return, but you failed to file such a return.

For new accounts paying interest or dividends, you must certify under penalties of perjury that your social security number is correct and that you are not subject to backup withholding. If you fail to make this certification, backup withholding may begin immediately on your new account or investment. Your payer will give you a **Form W-9,** *Request for Taxpayer Identification Number and Certification,* or a similar form, to make this certification.

In addition, transactions made by broker or barter exchanges may be subject to backup withholding.

Backup withholding may also apply to certain other reportable payments that payers make in the course of their trade or business. It applies if you are subject to backup withholding and:

- A payer pays you $600 or more during the year,
- The payer was required to file an information return for you for the prior year, or
- The payer was required to impose backup withholding on payments to you in the prior year.

Payments subject to backup withholding generally are not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on these payments.

For information on how to prevent backup withholding from starting, or on how to stop backup withholding once it has begun, see *Backup Withholding* in Chapter 1 of Publication 505, *Tax Withholding and Estimated Tax.*

Reporting backup withholding. If backup withholding is deducted from your interest or dividend income or other reportable payment, the bank or other business must give you an information return (for example, a Form 1099-INT, *Statement for Recipients of Interest Income*) that indicates the amount withheld. Any backup withholding will be shown on the information return as "Federal income tax withheld."

Nonresident aliens. Generally, payments of interest made to nonresident aliens are not subject to backup withholding. **Form W-8,** *Certificate of Foreign Status,* or a similar form, can be used to certify exempt status.

Penalties. There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000, or imprisonment of up to one year, or both.

For more information about backup withholding, see Publication 505.

Joint accounts. In a joint account, two or more persons, such as you and your spouse, hold a savings account, bond, stock, or other property that pays interest or dividends as joint tenants, tenants by the entirety, or tenants in common. Each person receives a share of any interest or dividends from the property. Each person's share is determined by local law.

Income from property given to a child. Property you give as a parent to your child under a Model Gifts of Securities to Minors Act, a Uniform Gifts to Minors Act, or any similar law, is a true gift for federal gift tax purposes.

Income from property transferred under these acts is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (parent or guardian) to the extent that it is used for the child's support.

Savings account with parent as trustee. Interest income derived from a savings account opened for a child or minor but placed in the name, and subject to the order, of the parents as trustees is taxable to the child, if, under the law of the state in which the minor resides:

1) The savings account legally belongs to the child, and
2) The parents are not legally permitted to use any of the funds to support the child.

Accuracy-related penalty. For tax returns due after 1989, a 20% accuracy-related penalty may be charged for underpayments of tax due to negligence or disregard of rules or regulations or substantial understatement of tax. For more information on the penalty and any applicable interest, see *Penalties* under *Tax Shelters,* later.

Interest Income

Words you may need to know (see Glossary):

- Accrual method
- Cash method
- Original issue discount
- Foregone interest

This section discusses the tax treatment of different types of interest income.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later.

Form 1099–INT. Interest income is generally reported to you on Form 1099–INT, *Statement for Recipients of Interest Income*, or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that is shown on any Form 1099–INT that you receive for the tax year. You must report all of your taxable interest income even if you did not receive a Form 1099–INT.

Nominees. Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT, showing the interest they received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions, later, under *How to Report Interest Income*.

Incorrect amount. If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099–INT you receive will be marked "CORRECTED."

Interest on Form 1099–OID. Reportable interest income may also be shown on Form 1099–OID, *Statement for Recipients of Original Issue Discount*. For more information about amounts shown on this form, see *Original Issue Discount (OID)*, later.

Individual Retirement Arrangements (IRAs). Interest that you earn on an IRA is not included in your income until you make withdrawals from the IRA. See Publication 590, *Individual Retirement Arrangements (IRAs)*, for more information.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the tax-exempt interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information-reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you are required to file. This is an information-reporting requirement and does not convert the exempt-interest dividend to taxable income. See *How to Report Interest Income*, later. Also, exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds. Specified private activity bonds are discussed later under *State or Local Government Obligations*. The interest on these bonds is a "tax preference item" that may be subject to the alternative minimum tax. See Publication 909, *Alternative Minimum Tax for Individuals*, for more information.

Interest income on frozen deposits. Under certain circumstances, you may choose to exclude from your income amounts of interest credited during 1990 on deposits that you could not withdraw by the end of 1990 due to the bankruptcy or insolvency of the financial institution, or because the state where the financial institution is located has placed limits on withdrawals because other banks in the state are bankrupt or insolvent.

The amount of interest you may exclude from gross income in 1990 is the interest that was credited on the frozen deposits minus the sum of:

1) The net amount you withdrew from these deposits during 1990, and
2) The amount you could withdraw as of the end of 1990 (not reduced by any penalty for premature withdrawals of a time deposit).

Report the excluded part of the interest in your gross income in the tax year in which it is withdrawable. If you receive a Form 1099–INT for interest income on deposits that were frozen at the end of 1990, see *Frozen deposits* later under *How to Report Interest Income*, for information about reporting this interest income exclusion on your 1990 tax return.

Taxable Interest

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most other sources. The following are some sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly referred to as dividends are actually interest. You must report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative Banks
- Credit Unions
- Domestic Building and Loan Associations
- Domestic Savings and Loan Associations
- Federal Savings and Loan Associations
- Mutual Savings Banks

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Money market certificates, savings certificates, and other deferred interest accounts. If you open any of these accounts, and interest is paid at fixed intervals of one year or less during the term of the account, you must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in one year or less and give a single payment of interest at maturity. If interest is deferred for more than one year, see *Original Issue Discount (OID)*, later.

Money borrowed to invest in money market certificate. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. You may deduct the interest you pay, as investment interest subject to certain limits, only if you itemize deductions.

Example. You deposit $5,000 with a bank and borrow $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6–month money market certificate. The certificate earns $575 at maturity in 1990, but you receive only $265 which represents the $575 you earned minus $310 interest charged on your $5,000 loan. The bank gives you a Form 1099–INT for 1990 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 1990. You must include the $575 in your income. You may deduct $310 on Schedule A (Form 1040) if you itemize your deductions, subject to the investment interest expense limitation.

The fair market value of "gifts" or services you receive for making long-term deposits or for opening an account in a savings institution is interest. Report it in income in the year you receive it.

Example. In 1990, you open a savings account at your local bank. The account earns $20, which is credited as interest. You also receive a $10 calculator. If no other interest is credited to your account during 1990, the Form 1099–INT you receive would show $30 interest income for 1990.

Interest on insurance dividends that you leave on deposit with an insurance company, that is credited annually, and that can be withdrawn annually, is taxable to you when the interest is credited to your account. However, if you can only withdraw it on the anniversary date of the policy (or other specified date), the interest is taxable in the year in which that date occurs.

Interest on GI insurance dividends you leave on deposit with the Department of Veterans Affairs is taxable.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw. Your insurance company must give you a Form 1099–INT showing the interest you earned for the year if you had $10 or more of interest income from that company.

Interest on U.S. obligations, such as U.S. Treasury notes and bonds, issued by any agency or instrumentality of the United States, is taxable for federal income tax purposes.

Interest on tax refund. If you receive a tax refund that includes interest on the amount refunded, the interest is taxable.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in payment of an award, the interest is taxable.

Installment sale payments. Certain deferred payments you receive under a contract for the sale or exchange of property provide for interest that is taxable. If little or no interest is provided for in certain contracts with payments due more than one year after the date of sale, each payment due more than 6 months after the date of sale will be treated as containing interest. The unstated interest rules apply to certain payments received on account of a ***seller-financed*** sale or exchange of property. See *Unstated Interest* in Publication 537, *Installment Sales*.

Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest is taxable unless state law automatically changes it to a payment on the principal. Usurious interest is interest charged at an illegal rate.

Interest on money deposited with a stockbroker. If you deposit money with your stockbroker who agrees to credit your account with an amount that can only be used to offset commissions due, the amount credited is not interest until it is actually applied to the commissions payable.

Accrued interest on bonds. If you sell bonds between interest payment dates, the accrued interest paid to you is taxable. See *Bonds Sold Between Interest Dates*, later.

Bonds traded flat. If you purchase bonds when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates.*

Below-Market Interest Rate Loans

If you make a below-market interest rate loan, you must report any foregone interest, defined next, arising from that loan as interest income. The income reporting treatment as well as the application of the below-market interest rate loan rules and exceptions are described in this section. If you receive a below-market interest rate loan, you may be able to claim an interest expense deduction in excess of any interest that you may have actually paid. See Publication 545, *Interest Expense,* for more information about this deduction.

Foregone interest. For any period, foregone interest is the amount of interest that would be payable for that period if interest accrued at the applicable federal rate and was payable annually on December 31, over any interest payable on the loan for such period. The ***applicable federal rate*** is set by the IRS each month and is published in the *Internal Revenue Bulletin.* You may also contact an IRS office to get these rates.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally recharacterized as an arm's-length transaction in which you, as the lender, are treated as having made:

1) A loan to the borrower in exchange for a note which requires the payment of interest at the applicable federal rate, and
2) An additional payment to the borrower.

Your additional payment to the borrower is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction. The borrower may have to report this payment as taxable income depending on its classification.

Loans subject to the rules. The rules for below-market loans apply to:

Gift loans,

Compensation-related loans,

Corporation-shareholder loans,

Tax avoidance loans,

Certain loans to qualified continuing care facilities (made after October 11, 1985), and

Other below-market loans.

Exceptions. The rules for below-market loans do not apply to:

1) Gift loans between individuals:
    a) On days on which the total outstanding amount of loans between such individuals is not more than $10,000, and
    b) The gift loan is not directly attributable to the purchase or carrying of income-producing assets; or
2) Compensation-related loans or corporation-shareholder loans:
    a) On days on which the total outstanding amount of loans between the borrower and lender is not more than $10,000, and
    b) The avoidance of federal tax is not a principal purpose of the loan.

Other loans not subject to the rules. Other loans are excluded from the below-market rules, including:

1) Loans made available by lenders to the general public on the same terms and conditions that are consistent with the lender's customary business practice,
2) Loans subsidized by a federal, state, or municipal government that are made available under a program of general application to the public,
3) Certain employee-relocation loans,
4) Loans to or from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and would not be exempt from U.S. tax under an income tax treaty, and
5) Other loans on which the interest arrangement can be shown to have no significant effect on the federal tax liability of the lender or the borrower.

If a taxpayer structures a transaction to be similar to a loan not subject to the rules, and one of the principal purposes of structuring the transaction is the avoidance of federal tax, the loan will be considered a tax-avoidance loan and subject to the rules for below-market loans.

All the facts and circumstances are used to determine if the interest arrangement of a loan has a significant effect on the federal tax liability of the lender or borrower. Some factors to be considered are:

- Whether items of income and deduction generated by the loan offset each other,
- The amount of such items,
- The cost of complying with the below-market loan provisions, if they applied, and
- Any reasons other than taxes, for structuring the transaction as a below-market loan.

Gift and demand loans. If you make a below-market gift demand loan or other demand loan (a loan payable in full at any time upon demand by the lender), you are treated as transferring an additional payment to the borrower (as a gift, dividend, etc.) in an amount equal to the foregone interest. The borrower is treated as transferring the foregone interest to you and may be entitled to an interest expense deduction. You, as the lender, must report that amount as interest income. These transfers are deemed to occur annually, generally on December 31.

Special rules for gift loans between individuals that do not exceed $100,000. For gift loans that do not exceed $100,000, the amount of foregone interest that is treated as transferred by the borrower to the lender is limited. This limit is the borrower's net investment income for the year, unless one of the principal purposes of the loan is the avoidance of federal tax. Also, if a borrower has net investment income of $1,000 or less for the year, the borrower's net investment income is deemed to be zero.

Term loans. If you make a below-market term loan (a loan that is not a demand loan), you are treated as transferring, as a gift, dividend, etc., an additional lump-sum cash payment to the borrower on the date the loan is made. The amount of this payment is the excess of the amount of the loan over the present value of all payments due under the loan. An amount equal to this excess is treated as original issue discount (OID). Accordingly, the OID rules of Section 1272 of the Internal Revenue Code apply. You must report the annual part of the OID as interest income, while the borrower may be entitled to deduct such amount. See *Original Issue Discount (OID),* later.

If you make a ***gift term loan,*** you are treated as transferring an additional amount to the borrower, as determined by using the rules for term loans. However, the amount of foregone interest that is treated as transferred by the borrower to you as interest income is determined using the rules for demand loans, discussed above.

Effective dates. These rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

For more information, see Section 7872 of the Internal Revenue Code and its regulations.

U.S. Savings Bonds

You may earn interest on U.S. Savings Bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued at a discount and pay all interest at redemption or maturity. The interest on the latter is the difference between what you pay for the bond and its redemption or maturity value.

This section provides information on different types of U.S. Savings Bonds, how to report the interest income on these bonds, and how to treat transfers of these bonds.

Accrual method taxpayers. If you are an accrual method taxpayer, you must report interest on U.S. Savings Bonds each year as it accrues. You may not defer reporting interest until you receive it or the bonds mature.

Accrual method is the accounting method you use to report your income when you earn it, whether or not you have received it. You deduct your expenses when you become liable for them rather than when you have paid them.

Cash method taxpayers. If you are a cash method taxpayer, as most individual taxpayers are, you generally report the interest on U.S. Savings Bonds when you receive it.

Cash method is the accounting method you use to report your income in the year in which you actually or constructively receive it. You deduct your expenses, except for certain prepaid interest, in the year you pay them.

Series HH Bonds. These bonds are issued at face value. Interest is paid twice a year by check. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH Bonds were first offered in 1980. Before 1980, ***Series H Bonds*** were issued. Series H Bonds are treated the same as Series HH Bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series EE Bonds. These bonds are issued at a discount. You pay less than the face amount for the bonds. The face amount is payable to you at maturity. The difference between the purchase price and the redemption value is taxable interest. Series EE Bonds were first offered in 1980. Before 1980, ***Series E Bonds*** were issued. If you own either Series EE or Series E Bonds and use the cash method of reporting income, you may:

1) Defer reporting the interest until the earlier of the year you cash the bonds or the year in which they finally mature (***method 1***), or
2) Choose to report the increase in redemption value as interest each year (***method 2***).

If you want to change your method of reporting the interest from method (1) to method (2), you may do so without permission from the IRS. However, in the year of change you must report all interest accrued to date and not previously reported for all such bonds.

Once you choose to report the interest each year, you must continue to do so for all Series EE or Series E Bonds you own and for any you get later, unless you request permission to change by filing **Form 3115,** *Application for Change in Accounting Method.*

Form 3115. To change from method (2) to method (1), complete Form 3115 and attach it to your income tax return for the year of change. Type or print at the top of page 1 of the Form 3115, *"Filed Under Rev. Proc. 89–46."* The return must be filed by the due date (including extensions). You must identify the savings bonds for which this change in accounting method is requested.

Permission for the change is automatically granted if you attach to Form 3115 a statement you agree to report all interest on the bonds uired:

During the year of change and for all subsequent tax years when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, and

Before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earlier, with the exception of any interest income previously reported in prior tax years.

lote: If you plan to redeem Series EE bonds ne same year that you will pay for higher eduonal expenses, you ***should*** use method (1) ve. See *Education Savings Bond Program* r for more information.

you hold the bonds beyond the original turity, and if you have chosen to report the rest each year, you must continue to do so ess you get permission to change your method eporting. If you have chosen to defer reporting interest, you need not include the interest in ome for the year of original maturity. Report it he year you redeem the bonds or the year in ch the extended maturity period ends, whichr is earlier. The original maturity period has en extended on all Series E Bonds.

Series E Bonds issued between May 1941 and il 1952 have a term of 40 years, and the partment of the Treasury has announced that further extension will be given to these bonds. erefore, if you have deferred reporting interest Series E Bonds purchased in 1950, you must ort the interest on your 1990 return, unless you de your Series E Bonds for Series HH Bonds.

-owners. If you buy a U.S. Savings Bond ued in your name and another person's name co-owners, such as you and your child or you d your spouse, interest on the bond is taxable the co-owner who bought the bond. If you used r funds to buy the bond, you must pay the tax the interest. This is true even if you let the er co-owner redeem the bond and keep all the ceeds. Under these circumstances, since the er co-owner will receive a Form 1099–INT at time of redemption, the other co-owner must ovide you with another Form 1099–INT showing amount of interest from the bond that is taxato you. See *Nominee distributions and accrued erest,* later, under *How to Report Interest come,* for more information about providing a rm 1099–INT to another person.

ild as only owner. Interest on U.S. Savings nds bought for and registered only in the name your child is income to your child, even if you id for the bonds and are named as beneficiary. e interest is income to your child when the nds mature or are cashed, unless your child ooses to report the interest income each year.

The choice to report the accrued interest nually may be made either by your child or by u for your child. This choice is made by filing an come tax return that shows all the interest rned to date, and by stating on the return that ur child chooses to report the interest each ar. Either you or your child should keep a copy this return.

Unless your child is otherwise required to file a x return, your child does not have to file another turn only to report the annual accrual of U.S. avings Bonds interest under this choice. Hower, see *Tax on investment income of a child der age 14,* earlier under *General Information.* either you nor your child may change the way u report the interest unless Form 3115 requestg permission to change is filed, as discussed rlier.

wnership transferred. If you bought Series EE Series E Bonds ***entirely with your own funds*** d have them reissued in your co-owner's name beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on such bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time. This same rule applies when bonds are transferred between spouses or incident to divorce.

Example. You bought Series E and Series EE Bonds entirely with your own funds and had not elected to report the accrued interest each year. You transfer the bonds to your former spouse under a divorce agreement. You must include the deferred accrued interest, from the date of the original issuance of the bonds to the date of transfer, in your income in the year of transfer. Your former spouse includes in income the interest on the bonds from the date of transfer to the date of redemption.

Purchased jointly. If you buy Series EE or Series E Bonds ***jointly*** with a co-owner and have them reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income-reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner, except that the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought ***jointly*** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example. You and your spouse each spent an equal amount to buy a $1,000 Series EE Savings Bond. The bond was issued to you as co-owners. You both defer reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue. But if you bought the $1,000 bond entirely with your own funds, you must report half the interest earned to the date of reissue. This is the previously deferred interest earned on the $1,000 bond that is attributable to the $500 bond issued to your spouse.

Transfer to a trust. If you own Series EE or Series E Bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you may continue to defer reporting the interest earned each year. You must include the total interest in your income when the bonds are cashed or finally mature, whichever is earlier.

The same rules apply to previously unreported interest on Series EE or Series E Bonds if the transfer to a trust consisted of Series HH or Series H Bonds you acquired in a trade for the Series EE or Series E Bonds. See *Savings bonds traded,* later.

Decedents. The manner of reporting interest income on Series EE or Series E Bonds, after death of the owner, depends on the accounting and income reporting method previously used by the decedent. If the bonds transferred because of death were owned by a person who used the accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

If the transferred bonds were owned by a decedent who had used the cash method and had not chosen to report the interest each year, and who had bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways:

1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent may choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then includes in income only interest earned after the date of death, or
2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of the decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she may defer reporting any of it until the bonds are cashed or finally mature, whichever is earlier. In the year that person reports the interest, he or she may claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

For more information on income in respect of the decedent, see Publication 559, *Tax Information for Survivors, Executors, and Administrators.*

Example 1. Your uncle, a cash method taxpayer, died and left you a $1,000 Series EE Bond. He bought the bond for $500 and had not chosen to report the interest each year. At the date of death, interest of $200 had accrued on the bond and its value of $700 was included in your uncle's estate. Your uncle's executor chose not to include the $200 accrued interest in your uncle's final income tax return.

You are a cash method taxpayer and do not choose to report the interest each year as it is earned. If you cash the bond when it reaches maturity value of $1,000, you report $500 interest income—the difference between maturity value of $1,000 and the original cost of $500. For that year, you may deduct (as a miscellaneous itemized deduction not subject to the 2% AGI limit) any federal estate tax paid because the $200 interest was included in your uncle's estate.

Example 2. If, in Example 1, the executor had chosen to include the $200 accrued interest in your uncle's final return, you would report only $300 as interest when you cashed the bond at maturity. This $300 is the interest earned after your uncle's death.

Example 3. When your aunt died, she owned Series H Bonds that she had acquired in a trade for Series E Bonds. (See *Savings bonds traded.*) You were the beneficiary of these bonds. Your aunt used the cash method and did not choose to report the interest on the Series E Bonds each year as it accrued. Your aunt's executor chose not to include any interest earned before your aunt's death on her final return.

The income in respect of the decedent is the sum of the unreported interest on the Series E Bonds and the interest, if any, payable on the Series H Bonds but not received as of the date of your aunt's death. You must report any interest received during the year as income on your return. The part of the interest that was payable but not received before your aunt's death is income in respect of the decedent and may qualify for the estate tax deduction. For information on when to report the interest on the Series E Bonds traded, see *Savings bonds traded,* next.

Savings bonds traded. If you traded Series E Bonds for Series H Bonds, or traded Series EE or Series E Bonds for Series HH Bonds, you did not realize taxable income unless you received cash in the trade. Any cash you received is income to the extent of the interest earned on the bonds traded. When your Series HH or Series H Bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of your cost of the traded Series EE or Series E Bonds plus any amount you had to pay at the time of the trade.

Example. You trade Series E Bonds with a redemption value of $2,723.35 for Series HH Bonds. You get $2,500 in Series HH Bonds and $223.35 in cash. You must report the $223.35 as taxable income in the year of the trade to the extent that you did not report interest on the Series E Bonds you traded.

$500 minimum value. Series EE or Series E Bonds that you want to trade must have a current redemption value of $500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

You can choose to treat all of the accrued interest on Series EE or Series E Bonds traded for Series HH Bonds as income in the year of the trade. If you make this choice, see the earlier discussion under *Series EE Bonds.*

Form 1099–INT for U.S. Savings Bonds Interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099–INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099–INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099–INT may show more interest than you are required to include on your income tax return. For example, this may happen if:

1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099–INT will not be reduced by amounts previously included in income.
2) You received a bond from a decedent. The interest shown on your Form 1099–INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
3) Ownership of a bond was transferred. The interest shown on your Form 1099–INT will not be reduced by interest that accrued prior to the transfer.
4) You redeemed a bond on which you were named as a co-owner but for which you did not use your funds to buy the bond. (See *Co-owners,* earlier in this section, for more information about the reporting requirements.)
5) You received a taxable distribution of bonds from a retirement or profit-sharing plan. The interest shown on your Form 1099–INT will not be reduced by the interest portion of amounts taxable as a distribution from a retirement or profit-sharing plan and not taxable as interest. (These amounts are generally shown on Form 1099–R, *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, Individual Retirement Arrangements, Insurance Contracts, Etc.*)

For information on including the correct amount of interest on your return, see *Interest from U.S. Savings Bonds* under *How to Report Interest Income,* later.

Note: Interest on U.S. Savings Bonds is exempt from state and local taxes. The Form 1099–INT you receive will indicate the amount that is for U.S. Savings Bonds interest in Box 3. Do not include this income on your state or local income tax return.

Education Savings Bond Program. Beginning in 1990, you may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. Savings Bonds if you pay qualified higher educational expenses during the year. This exclusion is known as the *Education Savings Bond Program.*

Married taxpayers who file separate returns ***do not*** qualify for this exclusion.

Qualified U.S. Savings Bonds. A qualified U.S. Savings Bond is a Series EE U.S. Savings Bond issued after December 31, 1989. The bond must be issued either in your name (sole owner) or in your and your spouse's name (co-owners). You must be at least 24 years old before the bond's issue date.

The date a bond is issued may precede the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased. You may designate any individual (including a child) as a beneficiary of the bond (payable on death).

Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent to attend an eligible educational institution. Eligible expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

Eligible educational institutions are those which qualify for federal assistance and include most public and nonprofit universities and colleges and certain vocational schools.

Amount excludable. To exclude all of the interest, the total redemption proceeds (interest and principal) from the qualified U.S. Savings Bonds you redeem during the year must not be more than your qualified higher educational expenses for the year. If the proceeds are more than the expenses, you will only be able to exclude part of the interest.

To determine the excludable amount, multiply the interest part of the redemption proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total redemption proceeds you received during the year.

Example. In December 1990, Mark and Joan, a married couple, cashed qualified Series EE U.S. Savings Bonds they bought in January 1990. That year, they helped pay for their daughter's college tuition. They received proceeds of $1,039.20, representing principal of $1,000 and interest of $39.20. The qualified higher educational expenses they paid during 1990 totaled $650. They can exclude $24.52 ($39.20 × ($650 ÷ $1,039.20)) of interest in 1990.

Exclusion reduced for certain benefits. Before you figure your interest exclusion, you must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include qualified scholarships that are exempt from tax and any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as Department of Veterans Affairs educational assistance benefits and employer-provided educational assistance benefits. See Publication 520, *Scholarships and Fellowships,* for more information on qualified scholarships.

Modified adjusted gross income limit. The interest exclusion is phased out if the modified adjusted gross income (modified AGI) is:

- $40,000 to $55,000 for taxpayers filing single, head of household, or qualifying widow(er) with dependent child; and
- $60,000 to $90,000 for married taxpayers filing jointly.

You do not qualify for the interest exclusion if your modified AGI is more than these limits.

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 16 of Form 1040A or line 31 of Form 1040) figured ***before*** the interest exclusion, modified by adding back any:

1) Foreign earned income exclusion,
2) Foreign housing exclusion or deduction,
3) Exclusion for income from certain U.S. possessions, and
4) Exclusion for income from sources within Puerto Rico.

If you do not have any of these items, your modified AGI is your adjusted gross income before the interest exclusion.

Form 8815. Use Form 8815, *Exclusion of Interest from Series EE U.S. Savings Bonds Issued After 1989,* to figure your exclusion and to compute your modified AGI.

Recordkeeping. If you claim the interest exclusion, you must keep a written record of the post-1989 Series EE U.S. Savings Bonds that you redeem. Your written record must include the serial number, issue date, face value, and redemption proceeds of each post-1989 Series EE bond. You may use **Form 8818,** *Optional Form To Record Redemption of College Savings Bonds,* to keep this information.

You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

U.S. Treasury Bills, Notes, and Bonds

Treasury bills, notes, and bonds are direct debts (obligations) of the United States Government.

Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. You should receive Form 1099–INT showing the amounts of interest (in Box 3) that were paid to you for the year.

Treasury bills. These bills are generally of 13–week, 26–week, and 52–week maturity periods and are issued at a discount. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Report this interest income when the bill is paid at maturity. Treasury bills are issued in denominations of $10,000 to $1,000,000.

If you reinvest your Treasury bill at its maturity for a new Treasury bill, a check for the difference between the proceeds of the maturing bill (par amount less any tax withheld) and the purchase price of the new bill will be sent to you. However, you must report the full amount of the interest income on each of your Treasury bills at the time it reaches maturity. Payments of principal and interest generally will be credited to your designated checking or savings account by direct deposit through the TREASURY DIRECT system.

Treasury notes and bonds. Treasury notes range in maturity periods from 1 to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both of these Treasury issues generally are issued in denominations of $1,000 to $1,000,000. Both notes and bonds generally pay interest every 6 months. Report this interest for the year paid. When the notes or bonds mature, you can redeem these securities for face value.

Treasury notes and bonds are usually sold by auction with competitive bidding. If, after compiling the competitive bids, a determination is made that the purchase price is less than the par value, you will receive the difference between the purchase price and the par value. This amount is considered a "discount." You consider this amount of discount ***de minimis*** and can disregard it and treat it as zero if it is less than one-fourth of 1% (.0025) of the face amount multiplied by the number of full years from the date of original issue to maturity. Examples of when you can disregard de minimis discount are shown later in the discussion under *Original Issue Discount (OID)*. If the purchase price is determined to be more than the face amount, you will be required to pay the premium.

Retirement, sale, or redemption. For information on the retirement, sale, or redemption of U.S. Government obligations, see *Capital or Ordinary Gain or Loss* and *Holding Period*, later. See also *Nontaxable Trades* for information about trading U.S. Treasury obligations for certain other designated issues.

Bonds Sold Between Interest Dates

When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of sale. The seller must report this amount as taxable interest. The purchaser may treat this amount as a capital investment and deduct it from the next interest payment as a return of capital, but must report the total payment as taxable interest and show the accrued interest as an adjustment (or subtraction). See *Nominee distributions and accrued interest* under *How to Report Interest Income*, later, for more information.

If the bond is an original issue discount (OID) debt instrument, see the discussion on OID, later, to determine the OID you must include in income. Also see *Original issue discount (OID)*, under *How to Report Interest Income*, for information on how to report OID on your income tax return.

If the bond has market discount, see the discussion under *Market Discount Bonds* for information about the accrued market discount that must be recognized as interest income.

Insurance Received in Installments

Life insurance proceeds paid to you as beneficiary of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract. If you receive life insurance proceeds in installments, you may exclude a part of each installment from your income. The same is true for a second beneficiary, if you, as the first beneficiary, were to die before you receive all of the installments.

To figure the excludable part of each installment, you must divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments that are to be paid. You must include in income, as interest, any amount that you receive that is more than this excludable part.

Specified number of installments. If you are entitled to receive a specified number of installments under the insurance contract, you figure the excludable part of each installment by dividing the amount held by the insurance company by the number of installments to which you are entitled.

Example. As beneficiary, you choose to receive $40,000 of life insurance proceeds in 10 yearly installments. During the year, you receive $6,000. You exclude from your gross income $4,000 ($40,000 ÷ 10). It is a return of principal. You must include the balance of the installment, $2,000, in your gross income as interest.

Specified amount payable. If each installment you receive under the insurance contract is a specific amount, the excludable part of each installment is the amount held by the insurance company divided by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example. The face amount of an insurance policy is $75,000 and, as beneficiary, you choose to receive monthly installments of $625. The insurer's settlement option guarantees this payment to you for 240 months. The part of each installment that you exclude from your income is $312.50 ($75,000 ÷ 240) or $3,750 for a year. You must include the balance of each payment, $312.50 ($625.00 minus $312.50), or $3,750 for a year, in your income as interest.

Installments for life. If, as the beneficiary under an insurance contract, you are entitled to receive the proceeds in installments for the rest of your life without a refund or "period-certain" guarantee, the part of each installment that you exclude from your income is the amount held by the insurance company divided by your life expectancy. If there is a refund or "period-certain" guarantee, reduce the amount held by the insurance company by the actuarial value of the refund or guarantee.

Surviving spouse. If insurance proceeds are payable to you because your spouse died before October 23, 1986, and you receive the proceeds in installments, you can exclude up to $1,000 a year of the interest included in the installments. This $1,000 interest exclusion is in addition to the part of each installment that you do not include in income because it is a recovery of the lump sum payable at death. If you later remarry, you can continue to take the $1,000 interest exclusion. If your spouse died after October 22, 1986, you do not qualify for the $1,000 interest exclusion.

Example. Fern Green, a widow whose husband died in June 1986, chooses to receive the proceeds of her husband's $75,000 life insurance policy in 10 yearly installments of $11,250. The payments are based on a certain guaranteed interest rate. She will include $2,750 in income each year. She figures this as follows:

Fixed payment	$11,250
Minus: Amount of insurance principal ($75,000 ÷ 10)	7,500
Interest included in installment	$ 3,750
Minus: Annual $1,000 interest exclusion	1,000
Amount included in gross income	$ 2,750

Interest option on insurance. If you leave proceeds from life insurance on deposit with an insurance company under an agreement to pay interest only, the interest paid to you is taxable.

The $1,000 interest exclusion, discussed under *Surviving spouse*, does not apply to an interest option. A surviving spouse of an individual who died before October 23, 1986, can, however, choose to receive only the interest from the insurance proceeds, and later decide to receive the proceeds from the policy in installments. You may take the $1,000 interest exclusion from the time you begin to receive the installments.

If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See Publication 939, *Pension General Rule (Nonsimplified Method)*.

State or Local Government Obligations

The interest that you receive on obligations of a state or local government may or may not be taxable depending on the type of obligation issued and the nature of the activity funded. This part of the publication provides general information for an investor on how to treat the interest from certain types of state or local government bonds, or other obligations, for income tax purposes. Transfers of these obligations are subject to federal estate, gift, and generation-skipping taxes, even if exempt for income tax purposes. The bond issuer should be able to tell you whether the interest from its obligations is taxable or nontaxable. The issuer should also provide you with a periodic (or year-end) statement that indicates the tax treatment of your investment. If you invested in state or local government obligations through an arrangement offered by a trust, a fund, or other organization, that organization should provide you with statements, or other information, advising you of the tax treatment of the interest you receive on such obligations.

If you want information about the specific requirements for issuance of state or local government obligations, consult the issuing governmental agency or refer to Section 103 and Sections 141 through 150 of the Internal Revenue Code, and their related regulations.

If you receive a Form 1099–INT for tax-exempt interest, see *Tax-exempt interest income* under *How to Report Interest Income*.

Tax-exempt interest on state or local obligations. Generally, interest on obligations of a state or one of its political subdivisions, the District of Columbia, a possession of the United States or one of its political subdivisions, used to finance governmental operations is not taxable. This includes:

Port authorities,
Toll road commissions,
Utility services authorities,
Community redevelopment agencies,
Qualified volunteer fire departments (for certain obligations issued after 1980), and
Similar bodies created for public functions.

Generally, a bond must be in registered form (if issued after June 30, 1983) for the interest to be tax exempt.

The interest is not taxable whether you receive it on a debt evidenced only by an ordinary written agreement of purchase and sale, or you receive the interest on a conventional bond or promissory note. It is also not taxable if paid by an insurer on default by the state or political subdivision.

Interest on obligations issued after 1982 by an Indian tribal government, which is treated as a state, is generally exempt from tax if such obligations are part of an issue of which substantially all of the proceeds are to be used in the exercise of any essential governmental function. However, except for interest on certain bonds for tribal manufacturing facilities, interest on its private activity bonds is taxable. Private activity bonds are discussed later.

Information-reporting requirement. If you received or accrued any tax-exempt interest income (such as interest on certain state and municipal bonds), you must show that interest on your tax return if you are required to file. This is an information-reporting requirement and does not convert tax-exempt interest to taxable interest. See *How to Report Interest Income*, later.

Taxable interest on state or local obligations. Interest on state or local obligations ***issued after 1983*** that are federally guaranteed is generally taxable. This applies to interest on obligations issued after April 14, 1983, if the obligation is issued as part of an issue and a significant part of the proceeds of the issue is to be directly or indirectly invested in federally insured deposits or accounts. There are exceptions to this rule. For example, interest is not taxable on obligations guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, and the Student Loan Marketing Association.

Mortgage revenue bonds. Generally, interest on state or local government home mortgage bonds issued after April 24, 1979, is taxable unless the bonds are qualified veterans' mortgage bonds or qualified mortgage bonds.

Arbitrage bonds. Interest on arbitrage bonds issued by state or local governments after October 9, 1969, is taxable. An arbitrage bond is an obligation issued by a state or local government, any portion of the proceeds of which is used to buy (or to replace funds used to buy) materially higher yielding investments. However, if the bond proceeds are part of a reasonably required reserve or replacement fund or invested for a temporary period until they are needed for the bond's original purpose, such bonds are not treated as arbitrage bonds.

Private activity bonds. Interest on a private activity bond that is not a qualified bond is taxable. Generally, a private activity bond is a state or local bond issue of which:

1) More than 10% of the proceeds of the issue is to be used by a private business, and
2) More than 10% of the payment of the principal or interest is:
    a) Secured by an interest in property used or to be used by a private business (or payments in respect of such property), or
    b) Derived from payments in respect of property (or borrowed money) used or to be used by a private business.

A bond is also considered a private activity bond if it meets the private loan financing test. This test is met if the amount of the proceeds to be used to make or finance loans to persons other than governmental units is more than 5% of the proceeds or $5 million (whichever is less).

A private activity bond is a ***qualified bond*** if the bond is an exempt-facility bond, qualified student loan bond, qualified small issue bond, qualified redevelopment bond, qualified mortgage bond, qualified veterans' mortgage bond, or qualified 501(c)(3) bond (i.e., a bond issued by certain charitable organizations). Thus, interest on these types of private activity bonds is tax exempt.

Interest that you receive on such tax-exempt bonds (except qualified 501(c)(3) bonds), if issued after August 7, 1986, generally is a "tax preference item" and may be subject to the alternative minimum tax. See Publication 909 for information.

Tax-exempt state and local bonds bought at a discount. The original issue discount (OID) on these bonds is not taxable. Any gain on their sale or redemption that is not more than your part of the OID is treated as nontaxable interest. Do not include this part of the gain in your income.

However, you must accrue OID on a tax-exempt obligation issued after September 3, 1982, that you acquired after March 1, 1984, to determine its basis when you dispose of it. See *Original issue discount (OID) on debt instruments* under *Stocks and Bonds,* covered later in *Sales and Trades of Investment Property.*

Stripped tax-exempt bonds or coupons. You must accrue OID on any stripped tax-exempt bond or coupon. A portion of this OID may be taxable. See *Stripped Bonds and Coupons* later under *Discount on Debt Instruments.*

If a state or local bond issued after June 8, 1980, is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain. If a state or local bond that was issued before June 9, 1980, is redeemed before it matures, the OID is not taxable to you.

Example. On July 1, 1980, the date of issue, you bought a 20–year, 6% municipal bond for $800. The face amount of the bond was $1,000. The $200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount 15 years after the issue date.

If the issuer redeems the bond at the end of the 15 years for its face amount of $1,000 plus accrued annual interest of $60, three-fourths (180 months ÷ 240 months) of the OID will be interest earned during the time you held the bond. This interest, $150, will not be taxable. The $60 accrued annual interest also will not be taxable. However, the balance of the OID, $50, will not be interest earned during the time you held the bond. You will have to report this unearned part of the OID as a capital gain.

Market discount on tax-exempt bonds. Any gain from market discount on tax-exempt bonds is taxable as a capital gain when you dispose of or redeem the bonds. You figure market discount by subtracting the price you paid for the bond from the total of the original issue price of the bond and the amount of OID that represented interest to any earlier holders. For information on taxable market discount bonds, see the discussion under *Market Discount Bonds* that appears later in the following section.

Discount on Debt Instruments

Words you may need to know (see Glossary):

Market discount bond
Original issue discount (OID)
Premium

In general, a debt instrument, such as a bond, note, debenture, or other evidence of indebtedness that bears no interest, or bears interest at a lower than current market rate, will usually be issued at less than its face amount. This discount is, in effect, additional interest income. The following are some of the types of discounted debt instruments which, in most instances, result in taxable income. See also *Real Estate Mortgage Investment Conduits (REMICs) and Other Collateralized Debt Obligations (CDOs),* later, for information about applying the rules discussed in this section to the regular interest holder of a REMIC or other CDO.

Original Issue Discount (OID)

A long-term debt instrument generally has original issue discount (OID) when the instrument is issued for a price that is less than its stated redemption price at maturity (principal amount). The amount of OID is the difference between the principal amount and the issue price of the instrument. OID is a form of interest; however, you report OID as it accrues, whether or not you receive any payments from the bond issuer. All long-term instruments that pay no interest prior to maturity are presumed to be issued at a discount. Zero coupon bonds are one example of such instruments.

The OID rules do not apply to short-term obligations, with a fixed maturity date of one year or less from date of issue. (See *Discount on Short-Term Obligations,* later.)

De minimis OID. You may disregard the discount and treat it as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as "de minimis" OID.

Example 1. You bought a 10–year bond with a stated redemption price at maturity of $1,000, issued at $980 and having OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, you may disregard the OID.

Example 2. Assume the same facts as in Example 1, except that the bond was issued at $950. The OID is $50. Because the $50 discount is more than the $25 figured in Example 1, you must report the OID.

Form 1099–OID. The issuer of the debt instrument (or your broker, if you purchased the instrument on a secondary market) should give you a copy of Form 1099–OID, *Statement for Recipients of Original Issue Discount,* or a similar statement, if the total OID for the calendar year is $10 or more. Form 1099–OID shows the amount of OID for the calendar year. It also will show the stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records. See *Recomputation of OID shown on Form 1099–OID,* later in this discussion, and also *Original issue discount (OID)* under *How to Report Interest Income,* for more information.

If you had OID for 1990 but did not receive a Form 1099–OID, see Publication 1212, *List of Original Issue Discount Instruments.* Publication 1212 lists total OID on certain debt instruments and gives information on computing OID. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the OID that accrued for 1990.

Nominee. If someone is the holder of record of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID. The form should show the OID for the entire year regardless of whether you owned or held the instrument for the entire year.

Debt instrument bought at a premium. If you bought at a premium a debt instrument that was originally issued at a discount, you do not have to report any OID as ordinary income. ***Premium*** means a purchase price that exceeds the stated redemption price of the instrument at maturity. When you sell or redeem an instrument bought at a premium, the difference between the sale or redemption price and your purchase price is a capital gain or loss.

This rule, however, does not apply if you bought a debt instrument and paid an acquisition premium. See *Acquisition premium,* later in this section, for more information about the treatment of this type of premium.

Exceptions to the OID rules. The OID rules discussed here for publicly-offered, long-term instruments do not apply to the following debt instruments:

1) Tax-exempt obligations (however, see *Stripped tax-exempt obligations* later),
2) U.S. Savings Bonds,
3) Short-term debt instruments which have fixed maturity dates of not more than one year from the date of issue,
4) Obligations issued by an individual before March 2, 1984, and
5) Loans of $10,000 or less between individuals (when increased by the outstanding amount of prior loans by that individual to the other individual) who are not in the business of lending money. (This exception does not apply if the principal purpose of the loan is to avoid any federal tax.)

Debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). For these instruments, you pay no tax on the OID until the year you sell, exchange, or redeem the instrument. If a gain results, and if the instrument is a capital asset, the amount of the gain equal to the OID is taxed as ordinary interest income. The balance of the gain is capital gain. If there is a loss on the sale of the instrument, the entire loss is a capital loss and no reporting of OID is required.

In general, the amount of gain taxed as ordinary interest income equals the following amount:

$$\frac{\text{Number of full months you held the instrument}}{\text{Number of full months from date of original issue to date of maturity}} \times \text{Original Issue Discount}$$

Corporate debt instruments issued after May 27, 1969, and before July 2, 1982. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year that you own the instruments. Your basis in the instrument is increased by the amount of OID that you include in your gross income.

If you bought the instruments ***at original issue*** and held them for all of 1990, or the part of 1990 that they were outstanding, include in your gross income the total OID from Form 1099–OID. If the instruments you bought at original issue were outstanding for all of 1990 but you did not hold them for the entire year, figure your taxable OID as follows. Divide the total OID for 1990 by 12 and multiply the result by the number of complete and partial ***months*** (for example, 6½ months) you held the instruments in 1990.

If you bought the instrument ***after its original issue,*** see *Recomputation of OID shown on Form 1099–OID,* later in this discussion, for more information.

Debt instruments issued after July 1, 1982, and before January 1, 1985. If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year and increase your basis by the amount included. You report the total OID from Form 1099–OID if you bought the instruments at original issue and held them for all of 1990 (or the part of 1990 that they were outstanding). However, if the instruments you bought at original issue were outstanding for all of 1990 but you did not hold them for the entire year, figure your taxable OID as follows. Divide the total OID for 1990 (shown on Form 1099–OID) by 365 and multiply the result by the number of ***days*** you held the instruments in 1990. This simple computation, however, is an approximation and may result in slightly higher taxable OID than if you follow the more exact constant interest method, using an accrual period of one year, as explained in Publication 1212 (under this same heading).

If you did not acquire the debt instrument at its original issue, see *Recomputation of OID shown on Form 1099–OID,* later in this discussion, for more information.

Debt instruments issued after December 31, 1984. If you hold these debt instruments, the OID reporting rules, in general, are similar to those for debt instruments issued after July 1, 1982. However, you report the total applicable OID (based on the number of days in the accrual period) regardless of whether you hold that debt instrument as a capital asset. Your basis in the instrument is increased by the amount of OID that you include in your gross income. The method for determining the reportable discount on any OID debt instrument issued after 1984 is based on an accrual period of 6 months. For more information about determining reportable OID for these debt instruments, see *Debt Instruments Issued After December 31, 1984,* in Publication 1212.

Recomputation of OID shown on Form 1099–OID. If you bought a debt instrument ***at original issue*** and held it for all of 1990, or the part of 1990 that it was outstanding, include in your gross income the total OID and any other periodic interest shown in Box 1 and Box 2 of Form 1099–OID. However, because the amount of OID shown on Form 1099–OID may have been determined on the assumption that you purchased the related debt instrument at original issue and owned it for the entire calendar year (or every day of the calendar year that the instrument was outstanding), the amount of OID shown in Box 1 of Form 1099–OID may not be the correct amount for you to include in your income.

You must recompute your correct share of the OID shown in Box 1 of Form 1099–OID if any of the following apply to your ownership or holding of a long-term OID debt instrument:

1) The corporate instrument bought by you at original issue was outstanding for all (or part) of 1990, but you did not hold it for the entire period it was outstanding in 1990, or
2) The corporate instrument was bought by you ***after its original issue,*** or
3) The debt instrument is a stripped bond or a stripped coupon (these include certain zero coupon instruments), as described later under *Stripped Bonds and Coupons.*

For each of these situations, see Publication 1212, which provides detailed information and examples about figuring the amount of OID to report on your income tax return. The rules for figuring OID are broken down in Publication 1212 to reflect the specific computations that apply to corporate long-term OID debt instruments issued before July 2, 1982, and to all long-term OID debt instruments issued after July 1, 1982.

Reporting correct amount of OID. If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, see *Original issue discount (OID)* under *How to Report Interest Income,* later, for information about reporting the correct amount of OID on Schedule B (Form 1040).

If a Form 1099–OID is not received. If you had OID for 1990 but did not receive a Form 1099–OID, see Publication 1212 which lists total OID on certain debt instruments. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the OID that accrued for 1990.

Acquisition premium. If you bought a debt instrument for more than the original issue price plus accumulated OID from the date of issue, that excess amount (or acquisition premium) reduces the amount of discount includible in your income. See *Computation of reportable OID* in Publication 1212 for information about figuring this reduction.

Recomputation of periodic interest shown on Form 1099–OID. If you disposed of a corporate debt instrument or acquired it from another holder during 1990, see *Bonds Sold Between Interest Dates,* earlier, for information about the treatment of periodic interest that may be shown in Box 2 of Form 1099–OID for that instrument. Also see *Nominee distributions and accrued interest* under *How to Report Interest Income,* later in this publication, for information about reporting the correct amount of interest on Schedule B (Form 1040).

Certificates of deposit (CD) and similar deposit arrangements. If you purchase a CD or a similar deposit arrangement and the receipt of interest is deferred for more than one year, you must include in income each year a part of the total interest due and report it in the same manner as other original issue discount (OID).

Examples of such deposit arrangements with banks, building and loan associations, etc., include:

Certificates of deposit
Time deposits
Bonus plans
Savings certificates
Deferred income certificates
Bonus savings certificates
Growth savings certificates

Interest subject to penalty for early withdrawal. If you make a deposit in one of the arrangements listed above that has a term of one year or less, and you cannot withdraw the interest without losing a large part of it, you must include all the interest in income at the end of the term. However, you can deduct the entire penalty, even if it exceeds your interest income, on line 28 of Form 1040.

Example. On October 1, 1990, you invested $10,000 in a savings certificate that will pay you $10,600 on April 1, 1991. If you withdraw any part of the principal or interest before April 1, you will lose the first $300 of interest that you accrue. If you wait until April 1 to withdraw your investment, you will include the entire $600 in your income for 1991.

Bearer certificates of deposit are not issued in the depositor's name and, therefore, are transferable from one individual to another. They are issued by banks for a deferred withdrawal period, usually a number of years. Interest is not usually paid until the certificates are redeemed by the bank at the end of this period.

Banks are required to provide the IRS and the person redeeming the bearer certificate with a Form 1099–INT.

Certificates of deposit issued after 1982 are generally required to be in registered form.

A "time deposit open account arrangement" is an arrangement with a fixed maturity date in which deposits are made on a schedule arranged between you and your bank. But there is no actual payment or constructive receipt of interest until the fixed maturity date is reached. For instance, you and your bank may enter into an arrangement under which you agree to deposit $100 each month for a period of 5 years, with interest compounded twice a year at 7½ percent, but payable only at the end of the 5–year period. You must include in your income each year a part of the interest.

All deposits under such an arrangement are part of a single obligation, but you must figure the OID separately for each deposit. Each year the financial institution must give you Form 1099–OID to show you the amount you must include in your income for the year.

If, before the maturity date, you redeem a deferred interest account for less than its stated redemption price at maturity, you can deduct the amount of OID that you previously included in income but did not receive.

Partial redemption. If you redeem only a part of a deferred account before the maturity date, the adjusted basis of the unredeemed part of the obligation on the date of partial redemption is equal to the adjusted basis of the entire obligation on that date minus the amount paid on the redemption.

Face-amount certificates are subject to the OID rules. These certificates are a form of endowment contract issued by insurance or investment companies for either a lump-sum payment or periodic payments, with the face amount becoming payable on the maturity date of the certificate.

If you paid a lump sum, the difference between the face amount and the amount you paid for the contract is OID. You must include a part of the OID in your income over the term of the certificate.

If you make periodic payments, you figure the OID for each payment separately.

The issuer must give you a statement on Form 1099–OID indicating the amount you must include in your income each year.

Stripped Bonds and Coupons

The act of stripping one or more coupons from a bond and selling the bond or such coupons causes the bond and coupons to be treated as separate debt instruments issued with OID.

Stripped bonds and stripped coupons include zero coupon instruments available through either the Department of the Treasury's STRIPS program, government-sponsored enterprises such as the Resolution Funding Corporation and the

Financing Corporation, or as instruments backed by U.S. Treasury securities that represent ownership interests in those securities. Examples of such zero coupon instruments include those obligations backed by U.S. Treasury bonds that are offered primarily by brokerage firms (variously called CATS, TIGRs, etc.).

Seller of stripped bond or coupon. If you strip coupons from a bond and sell the bond or coupons, include in income the interest that accrued before the date of sale to the extent this interest was not previously included in your income. For an obligation that you acquire after October 22, 1986, you must also include the market discount that accrued before the date of sale of the stripped bond (or coupon) to the extent this discount was not previously included in your income.

During the period you own or hold the bond and coupons, you add the accrued interest (and market discount) to the basis of the bond and coupons. This adjusted basis is then allocated between the items you keep and the items you sell, based on the fair market value of the items. The difference between the sale price of the bond (or coupon) and the allocated basis of the bond (or coupon) is the gain or loss from the sale.

If you keep the bond, treat the excess of the redemption price of the bond over the basis of the bond as the OID. If you keep the coupons, treat the excess of the amount payable on the coupons over the basis of the coupons as the OID.

Purchaser of stripped bond or coupon. If you purchase a stripped bond or stripped coupon, the bond or coupon is treated as if it were originally issued on the date you purchase it. If you purchase a stripped bond, treat as the OID any excess of the stated redemption price at maturity over the bond's purchase price. If you purchase the stripped coupon, treat as the OID any excess of the amount payable on the due date of the coupon over the coupon's purchase price.

Figuring OID on stripped bonds and coupons. The rules for figuring OID on stripped bonds and stripped coupons depend on the date such debt instruments were purchased and not on the date the instruments were offered. Moreover, because of the change in method of determining an "accrual period," the rules for figuring OID on stripped bond and coupon instruments purchased before 1985 differ from the rules that apply to similar instruments purchased after 1984. For information about figuring the correct amount of OID on these instruments to include in your income, see *Rules for Figuring OID on Stripped Bonds and Stripped Coupons* in Publication 1212.

Stripped tax-exempt obligations. You do not have to pay tax on OID on any stripped tax-exempt bond or coupon that you bought or sold ***after October 22, 1986, and before June 11, 1987.*** However, you must accrue OID on such an instrument to determine its basis when you dispose of it. See *Original issue discount (OID) on debt instruments* under *Stocks and Bonds,* covered later in *Sales and Trades of Investment Property.*

You may have to pay tax on part of the OID on stripped tax-exempt bonds or coupons that you bought or sold ***after June 10, 1987.*** You determine the OID on the stripped bond or coupon under the general rule for such obligations. The excess of this amount over the amount determined to be OID under the rule for tax-exempt stripped bonds or coupons as explained in Publication 1212 is treated as OID on an obligation that is not tax exempt.

This rule does not apply if such stripped bond or coupon was held for sale on June 10, 1987, in the ordinary course of the holder's trade or business. Nor does it apply to a person who purchased it from such a holder. As with such instruments purchased earlier, your basis is increased by the total OID determined for each accrual period.

Example. A tax-exempt obligation is issued for $100 on January 1, 1988, with a coupon rate of 10% (compounded semiannually). It is stripped on January 1, 1990, and matures for a face value of $100 on January 1, 1991. The right to receive the principal amount is sold for $79.21, reflecting a 12% (compounded semiannually) yield to maturity at the time of the strip. The tax-exempt part of OID on the stripped bond is limited to $17.73, which is the difference between the stated redemption price of the obligation ($100) and the issue price that would produce a 10% yield to maturity ($82.27). The part of the OID that is treated as coming from an obligation that is not tax exempt is $3.06, which is determined by finding the excess of total OID on the stripped bond ($20.79) over the tax-exempt OID portion ($17.73).

Market Discount Bonds

A market discount bond is any bond having market discount except:

1) Short-term obligations with fixed maturity dates of up to one year from the date of issue,
2) Tax-exempt obligations,
3) U.S. Savings Bonds, and
4) Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If you buy a bond on the secondary market, it may have market discount.

If you dispose of a market discount bond issued after July 18, 1984, you generally must recognize the gain as interest income to the extent of the bond's ***accrued market discount.*** The balance of the gain is a capital gain if the bond was a capital asset. See also *Special rule for market discount bonds with partial principal payments,* later in this discussion.

If you dispose of a market discount bond issued before July 19, 1984, any gain is treated as interest income to the extent of the deferred interest expense you are allowed to deduct in the year you dispose of the bond. The balance of the gain is capital gain. (Deferred interest expense is discussed under *Investment Expenses,* later.)

Market discount is the excess of the stated redemption price of a bond at maturity over your basis in the bond immediately after you acquire it. You may disregard market discount and treat it as de minimis. That is, the market discount is treated as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price of the bond multiplied by the number of full years to maturity (after you acquire the bond).

If a market discount bond also has OID, the market discount is the sum of the bond's issue price, plus the total OID includible in the gross income of all holders before you acquired the bond, reduced by your basis in the bond immediately after you acquired it.

Bonds acquired at original issue. Generally, the accrued market discount rules in effect for a market discount bond issued after July 18, 1984, do not apply to a bond that you acquired at original issue. If your adjusted basis in a bond is determined by reference to the adjusted basis of another person who acquired the bond at original issue, you are also considered to have acquired it at original issue. However, the accrued market discount rules apply to these bonds if:

1) Your cost basis in the bond is less than the bond's issue price; or
2) The bond you held was issued in exchange for a market discount bond under a plan of reorganization. (The accrued market discount rules, however, do not apply if the bond is issued in exchange for a market discount bond issued before July 19, 1984, and the terms and interest rates of both bonds are identical.)

Accrued market discount. The accrued market discount is figured in one of two ways.

Ratable accrual method. Treat the market discount as accruing in equal daily installments during the period you hold the bond. The daily installments are determined by dividing the market discount by the number of days after the date you acquired the bond, up to and including its maturity date. Multiply the daily installments by the number of days you held the bond to determine your accrued market discount.

Constant interest method. Instead of using the ratable accrual method, you may choose to determine the accrued discount using the alternative computation that is also used to figure daily portions of OID for corporate obligations issued after July 1, 1982. For more information about using the constant interest method and formula, see Publication 1212. If you are using this computation method for a market discount bond, treat the bond as being issued on the date you acquire it and the amount of your basis (immediately after you acquire the bond) as the issue price in applying the formula shown in Publication 1212. If you choose to use this method for any bond, you may not change your choice for that bond.

Choosing to include market discount in income currently. Instead of recognizing interest income when you dispose of a market discount bond as previously discussed, you can choose to include market discount in your interest income for the year to which it is attributable. You may use either the ratable accrual method or the constant interest method to figure the amount includible in income.

If you make this choice, the interest-deferral rule discussed later under *Investment Expenses* will not apply. Once you make this choice, it will apply to all market discount bonds that you acquire during the tax year and in later tax years. You increase the basis of your bonds by the amount of market discount you include in your income. You may not revoke your choice without the consent of the IRS.

Special rule for market discount bonds with partial principal payments. For market discount bonds that you acquire after October 22, 1986, you must include any partial principal payment that you receive for the bond in your gross income as ordinary income to the extent of that bond's accrued market discount. If you dispose of a market discount bond on which you received a partial principal payment, reduce the amount of accrued market discount reportable at disposition by the amount of any partial principal payment that you previously included in your gross income.

For a market discount bond acquired after October 22, 1986, on which the principal is paid in more than one payment, special interim guidelines are provided (until such time as Treasury regulations are issued) for determining accrued market discount. If you are a holder of this type of debt instrument, you can choose to accrue market discount:

1) On the basis of the constant interest method, described earlier; or
2) In proportion to the accrual of OID for any accrual period, if the debt instrument has OID; or
3) In proportion to the amount of stated interest paid in the accrual period, if the debt instrument has no OID.

For debt instruments ***with OID,*** you may accrue market discount during a period by multiplying the total remaining market discount by a fraction: the numerator is the OID for the period and the denominator is the total remaining OID at the beginning of the period.

For debt instruments ***without OID,*** you may accrue market discount during a period by multiplying the total remaining market discount by a fraction: the numerator is the stated interest paid in the accrual period and the denominator is the total stated interest remaining to be paid at the beginning of the accrual period.

Discount on Short-Term Obligations

Certain holders of short-term obligations are required to accrue and include the discount on such obligations in current income. This current income inclusion rule applies to any short-term obligation (with a fixed maturity date of one year or less from date of issue) that is:

1) Held by an accrual-basis taxpayer,
2) Held primarily for sale to customers in the ordinary course of your trade or business,
3) Held by a bank, regulated investment company, or common trust fund,
4) Held by certain pass-through entities,
5) Identified as part of a hedging transaction, or
6) A stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis in the obligation is determined by reference to the basis in the hands of such person).

Government obligations. If you are one of the holders described above, and you acquire a short-term government obligation (that is not a tax-exempt obligation), you will apply the current income inclusion rules by taking into account the amount of the acquisition discount on those obligations.

The amount of the ***acquisition discount*** (stated redemption price at maturity over your basis) that is includible in income for the tax year is found by using either the ***ratable accrual method,*** discussed previously in *Accrued market discount* under *Market Discount Bonds*, or by electing to use the ***constant interest method.*** This alternative computation is the same as that used to figure daily portions of OID for instruments issued after December 31, 1984, as described in Publication 1212.

However, if you are using this computation method for a short-term government obligation, treat your cost of acquiring the obligation as the issue price in applying the constant interest formula. If you choose to use the alternative computation for any short-term government obligation, you may not change your choice.

Interest payable. You must also include any interest payable on the obligation in your gross income as the interest accrues. However, do not include any interest that you took into account in determining the amount of acquisition discount.

Cash-basis taxpayers. The current income inclusion rules described in this section apply only to the holders listed above. If you are a cash-basis taxpayer and hold a short-term government obligation, follow the rules for reporting interest income discussed earlier under *U.S. Treasury Bills, Notes, and Bonds* or *State or Local Government Obligations*, as applicable. However, for purposes of determining gain on short-term government obligations, you must take into account the amount of acquisition discount under one of the two methods described earlier. For more information about the tax treatment of the gain on such obligations, see the discussion in *Capital or Ordinary Gain or Loss*, later in this publication.

The interest expense deferral rule, discussed later under *Investment Expenses*, will apply to interest expenses you incurred to purchase or carry short-term obligations. However, that rule will not apply if you choose to accrue and include acquisition discount, under the current income inclusion rules described in this section, on all short-term obligations you acquire during the year and in all later years. The procedures to use in making this choice are the same as those described next for reporting acquisition discount on nongovernmental obligations. However, in this case, you should indicate that you are making the choice under Section 1282(b)(2) of the Code.

Nongovernmental obligation. If you are one of the holders listed above, and you acquire a short-term nongovernmental obligation, you generally will apply the current income inclusion rules by taking into account the amount of OID rather than the acquisition discount. (In this case, if you choose the constant interest method in lieu of the ratable accrual method, as described earlier for government obligations, use the obligation's issue price in applying the constant interest formula.) Or you may choose to report the daily portions of acquisition discount on such short-term obligations. Your choice will apply to the year for which it is made and to all later years and cannot be changed without the consent of the IRS.

You must make your choice by the due date of your return, including extensions, for the first year for which you are making the choice. Attach a statement to your return or amended return indicating:

1) Your name, address, and social security number,
2) The choice you are making and that it is being made under Section 1283(c)(2) of the Code,
3) The period for which the choice is being made and the property to which it applies, and
4) Any other information necessary to show you are entitled to make this choice.

Interest payable. You must also include any interest payable on the obligation in your gross income as the interest accrues. However, do not include any interest that you took into account in determining the amount of OID.

Cash-basis taxpayers. If you are a cash-basis taxpayer and hold a short-term nongovernmental obligation, report the discount as interest income at the time the obligation is redeemed or matures. However, for purposes of determining gain on short-term nongovernmental obligations, you must take into account the OID under either the ratable accrual method or the constant interest rate method. For more information about the tax treatment of the gain on such obligations, see the discussion in *Capital or Ordinary Gain or Loss*, later in this publication.

The interest expense deferral rule, discussed later under *Investment Expenses*, will apply to interest expenses you incurred to purchase or carry short-term obligations. However, that rule will not apply if you choose to accrue and include acquisition discount, under the current income inclusion rules described in this section, on all short-term obligations you acquire during the year and in all later years. The procedures to use in making this choice are the same as those described for reporting acquisition discount on nongovernmental obligations. However, in this case, you should indicate that you are making the choice under Section 1282(b)(2) of the Code.

When to Report Interest Income

Words you may need to know (see Glossary):

Accrual method
Cash method

When you report your interest income depends on whether you use the cash-basis or the accrual-basis method to report income.

Cash basis. If you use this method, you report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. However, there are special rules for OID and certain U.S. Savings Bonds. See *U.S. Savings Bonds* and *Original Issue Discount (OID)*, earlier.

Example. On September 1, 1988, you loaned $2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1990. In 1990, you received $2,480 ($2,000 principal and $480 interest). If you use the cash-basis method, you must include in income on your 1990 return the $480 interest you received in 1990.

You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

1) Make withdrawals in multiples of even amounts,
2) Give a notice to withdraw before making the withdrawal,
3) Withdraw all or part of the account to withdraw the earnings, or
4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

You constructively receive interest when it is credited to your account under a long-term savings plan that does not let you withdraw interest until a specific date, if the plan lets you freely withdraw your deposits of principal.

Accrual basis. If you use this method, you report your interest income when you earn it, whether or not you have received it.

Example. If, in the above example, you use the accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1988, $80; 1989, $240; and 1990, $160.

Coupon bonds. Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

How to Report Interest Income

Words you may need to know (see Glossary):

Market discount
Original issue discount (OID)

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ. If your interest income is more than $400 or you are excluding interest under the Education Savings Bond Program, you may not use Form 1040EZ. Instead, you must complete the schedules for Form 1040A or Form 1040, as described later. In addition, you must use Form 1040 under certain circumstances described later.

Form 1099–INT. Your taxable interest income is shown in Box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received.

If you had any tax-exempt interest income, or exempt-interest dividends from a mutual fund, you should report the total of this tax-exempt income on line 8b of Form 1040A or Form 1040, or write "TEI" in the space to the left of line 2 on Form 1040EZ. After "TEI," show the amount of your tax-exempt interest, but do not add tax-exempt interest in the total on Form 1040EZ, line 2.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT, in Box 2 (early withdrawal penalty). If an amount appears in Box 2, you should file Form 1040, and report this amount on line 28 (penalty on early withdrawal of savings).

Box 3 of Form 1099–INT shows the amount of interest income you received from U.S. Savings Bonds, Treasury bills, Treasury notes, and Treasury bonds. Include the amount shown in Box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If you are redeeming U.S. Savings Bonds you bought after 1989 **and** you have qualified educational expenses, see *Form 8815* later. If part of the amount shown in Box 3 was previously included in interest income, see *Interest from U.S. Savings Bonds*, next.

If you were subject to backup withholding, because, for example, you did not furnish your social security number to a payer, an amount will appear in Box 4 of Form 1099–INT (federal income tax withheld). Report the amount from Box 4, on Form 1040A, line 28a, or on Form 1040, line 55 (federal income tax withheld), and check the box.

If there are entries in Boxes 5 and 6 of Form 1099–INT, you must file Form 1040. Report the amount shown in Box 5 (foreign tax paid) on **Form 1116**, *Foreign Tax Credit*, unless you claim this amount on Schedule A of Form 1040 as other taxes. For more information on the credit and deduction, see Publication 514, *Foreign Tax Credit for Individuals*.

Interest from U.S. Savings Bonds. If you received a Form 1099–INT for U.S. Savings Bond interest, the form may show interest you are not required to report. See *Form 1099–INT for U.S. Savings Bonds interest*, earlier, under *U.S. Savings Bonds*.

If you have qualified educational expenses (as discussed earlier under *Education Savings Bond Program* earlier), see *Form 8815* later for information on your interest exclusion.

You should show on line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), all the interest shown on your Form 1099–INT.

If Form 1099–INT includes interest you previously reported, make the following adjustment. On Schedule B, several lines above line 2, enter a subtotal of all interest listed on line 1. If you use Form 1040A, enter this subtotal several lines above line 2, Part I of Schedule 1. Below the subtotal write "U.S. Savings Bond Interest Previously Reported" and enter amounts previously reported or interest accrued prior to receiving the bond. (To figure the amount to enter for interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan, see *Worksheet for a taxable distribution of U.S. Savings Bonds from a retirement or profit-sharing plan*, later.) Subtract these amounts from the subtotal and enter the result on line 2 of Schedule B (Form 1040), or on line 2, Part I of Schedule 1 (Form 1040A).

Example 1. Your parents purchased U.S. Savings Bonds for you when you were a child. The bonds were issued in your name and the interest on the bonds was reported each year as it accrued. (See *The choice to report the accrued interest annually* under *U.S. Savings Bonds*, earlier.)

In April 1990, you redeem one of the bonds your parents purchased—a $1,000 Series E Bond. The bond was originally issued in March 1968. You received $3,158.00 for the bond.

The Form 1099–INT you receive shows interest income of $2,408.00. However, since the interest on your savings bonds was reported yearly, you need only include the $125.20 interest that accrued from January 1990 to April 1990.

You received no other taxable interest for 1990. You file Form 1040A.

On line 1, Part I of Schedule 1 (Form 1040A), enter your interest income — $2,408.00. Several lines above line 2, put a subtotal of all interest listed on line 1. Below this subtotal, write "U.S. Savings Bond Interest Previously Reported" and enter $2,282.80 ($2,408.00 − $125.20 interest for 1990). Subtract $2,282.80 from $2,408.00 and write $125.20 on line 2, Part I of Schedule 1. Enter $125.20 on line 4 of Schedule 1 and on line 8a of Form 1040A.

Example 2. In the facts of Example 2 under *Decedents* in the discussion *U.S. Savings Bonds*, earlier, your uncle died and left you a $1,000 Series EE Bond. You redeem the bond when it reaches maturity value.

Your uncle paid $500 for the bond, so $500 of the amount you receive upon redemption is interest income. Your uncle's executor included in your uncle's final return $200 of the interest which had accrued at the time of your uncle's death. Therefore, you are only required to include $300 in your income.

The bank where you redeem the bond gives you a Form 1099–INT showing interest income of $500. You also receive a Form 1099–INT showing taxable interest income of $300 from your savings account.

You file Form 1040 and you complete Schedule B. On line 1 of Schedule B, you include the $800 interest shown on your Forms 1099. Several lines above line 2, you put a subtotal of all interest listed on line 1. Below this subtotal, write "U.S. Savings Bond Interest Previously Reported" and enter the $200 interest included in your uncle's final return. Subtract the $200 from the subtotal and write $600 on line 2. You then complete the rest of the form.

Worksheet for a taxable distribution of U.S. Savings Bonds from a retirement or profit-sharing plan. Use the worksheet below to determine the interest reported or being reported as a taxable distribution from a retirement or profit-sharing plan.

A. Write the amount of cash received upon redemption of the bond. .... $_____

B. Write the value of the bond at the time of distribution by the plan. .... _____

C. Subtract the amount on line B from the amount on line A. This is the amount of interest accrued on the bond since it was distributed by the plan. .... $_____

D. Write the amount of interest shown on your Form 1099–INT. .... $_____

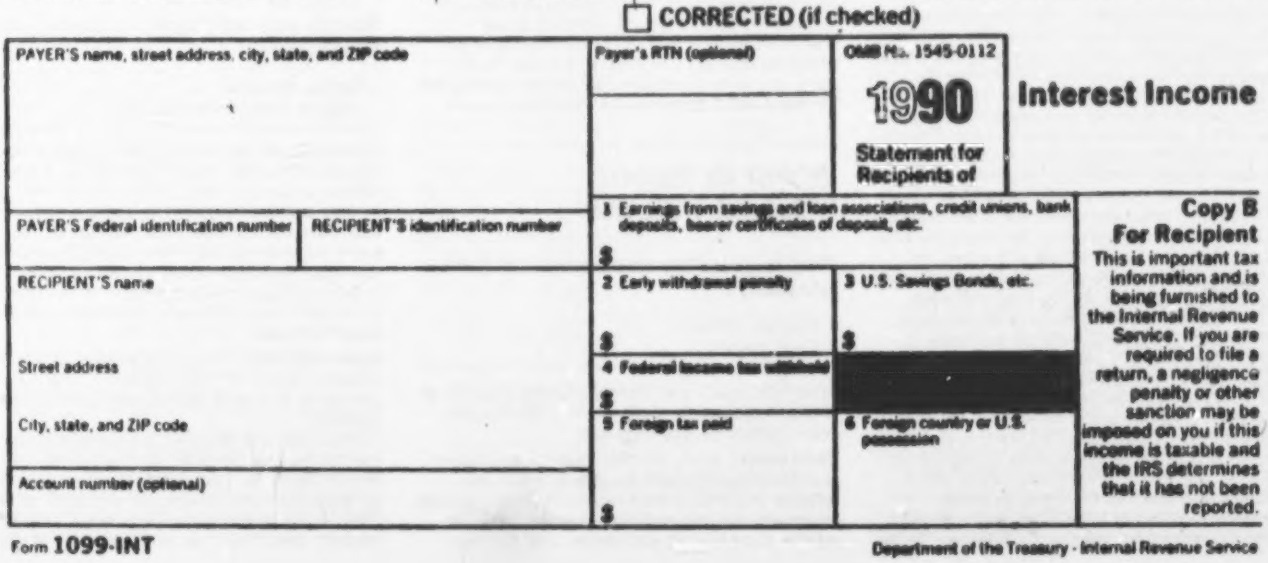
E. Subtract the amount on line C from the amount on line D. This is the amount you include in the subtotal "U.S. Savings Bond Interest Previously Reported." .... $_____

Your employer should tell you the value of each bond on the date it was distributed.

Example. You received a distribution of Series EE Savings Bonds in January 1989 from your company's profit-sharing plan.

In April 1990, you redeem a $100 Series EE Bond that was part of the distribution you received in 1989. You receive $83.28 for the bond. The company told you that the bond was purchased in May 1983 for $50 and that the value of the bond at the time of distribution in 1989 was $78.00. (This is the amount you included on your 1989 return.) The bank gives you a Form 1099–INT that shows $33.28 interest (the total interest from the date the bond was purchased to the date of redemption). Since a part of the interest was included in your income in 1989, you need only include the interest that has accrued since the bond was distributed to you.

On line 1 of Schedule B (Form 1040), include all the interest shown on your Form 1099–INT as well as any other taxable interest income you received.



☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	Payer's RTN (optional)	OMB No. 1545-0112 1990 Statement for Recipients of	Interest Income
PAYER'S Federal identification number | RECIPIENT'S identification number	1 Earnings from savings and loan associations, credit unions, bank deposits, bearer certificates of deposit, etc. $		Copy B For Recipient This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name	2 Early withdrawal penalty $	3 U.S. Savings Bonds, etc. $	
Street address	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid $	6 Foreign country or U.S. possession	
Account number (optional)			

Form 1099-INT

Department of the Treasury - Internal Revenue Service

Several lines above line 2, put a subtotal of all interest listed on line 1. Below this subtotal write "U.S. Savings Bond Interest Previously Reported" and enter the amount as figured on the worksheet below.

A. Write the amount of cash received upon redemption of the savings bond.	$83.28
B. Write the value of the bond at the time of distribution by the plan.	78.00
C. Subtract the amount on line B from the amount on line A. This is the amount of interest accrued on the bond since it was distributed by the plan.	$5.28
D. Write the amount of interest shown on your Form 1099–INT.	$33.28
E. Subtract the amount on line C from the amount on line D. This is the amount you include in the subtotal "U.S. Savings Bond Interest Previously Reported."	$28.00

Subtract $28.00 from the subtotal and enter the result on line 2 of Schedule B. You then complete the rest of the form.

Form 8815. Use Form 8815, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989*, to figure your interest exclusion when you redeem bonds and pay qualified higher educational expenses during the same year.

For more information on the exclusion and qualified higher educational expenses, see the earlier discussion under *Education Savings Bond Program.*

You do not qualify for the exclusion if you are married filing separately.

You must show your total interest from Series EE Savings Bonds on line 6 of Form 8815 and on line 1 of either Schedule 1 (Form 1040A) or Schedule B (Form 1040). After completing Form 8815, enter the result from line 14 (Form 8815) on line 3 of Schedule 1 (Form 1040A) or line 3 of Schedule B (Form 1040).

Form 1040A

If your taxable interest income totals more than $400 or you are claiming the interest exclusion under the Education Savings Bond Program, you must complete Part I of Schedule 1 (Form 1040A). List each payer's name and the amount of interest income received from each payer. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer. Attach Schedule 1 to your return.

However, you must use Form 1040 instead of Form 1040A if:

- You are reporting OID in an amount greater or less than the amount shown on Form 1099–OID,
- You received or paid accrued interest on securities transferred between interest payment dates, or
- You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (discussed later under *Bond Premium Amortization*).

Nominee distributions. If the total interest income you list on line 1, Part I of Schedule 1 (Form 1040A), includes any amount that you received as a nominee for the real owner, show such an amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distributions" and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule 1 (Form 1040A), and also on Form 1040A, line 8a.

For more information, see *Nominee distributions and accrued interest* later under *Form 1040.*

Tax-exempt interest income. If you received any tax-exempt interest, such as from state or local governmental obligations, do not include this income on line 8a. Instead, enter your tax-exempt interest on line 8b. Also include on line 8b any exempt-interest dividends received from a mutual fund or other regulated investment company.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

If you are completing Part I of Schedule 1 (Form 1040A), include the tax-exempt interest on line 1 only if you received a Form 1099–INT for that interest. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Tax-Exempt Interest" and show the amount of this interest. Subtract this amount from the subtotal and write the result on line 2 of Part I. Subtract the amount you figured on Form 8815 on line 3 from the amount on line 2 and enter the result on line 4 of Schedule 1 and on line 8a of Form 1040A. Be sure to show the tax-exempt interest on line 8b.

Frozen deposits. If you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1990, you can choose to exclude such amounts from your gross income (see *Interest income on frozen deposits* earlier under *Interest Income*). If you make this choice, do not include this income on line 8a. If you are completing Part I of Schedule 1 (Form 1040A), include in line 1 the interest shown on Form 1099–INT. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2 of Part I (Schedule 1).

Form 1040

If your taxable interest income is more than $400 or you are claiming the interest exclusion under the Education Savings Bond Program, and you file Form 1040, you must attach a Schedule B to your return and list each payer's name and the amount received from each.

Report on line 1, Part I of Schedule B, all taxable interest, including seller-financed mortgage interest. Include the total amount of interest income that is shown in Box 1 and Box 3 of any Form 1099–INT or in Box 1 and Box 2 of any Form 1099–OID that you receive for the tax year, and other interest income received for which you did not receive a Form 1099. List each payer's name and the amount of interest received from each. If you receive a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer. You must also complete Part III of Schedule B.

If you redeemed Series EE U.S. Savings Bonds and you have qualified educational expenses, complete and attach Form 8815. Enter the result from line 14 of Form 8815 on line 3 of Schedule B. For more information on this interest exclusion, see *Education Savings Bond Program* and *Form 8815*, earlier.

Tax-exempt interest income. If you received any tax-exempt interest income (such as interest on certain state and municipal bonds), you must report the total amount of that interest on line 8b of Form 1040. Also report on line 8b any exempt-interest dividends that you received from a mutual fund or other regulated investment company. Do not include this interest in your taxable interest income on line 8a. If you are completing Part I of Schedule B (Form 1040), report tax-exempt interest on line 1 only if you received a Form 1099-INT for that interest. Several lines above line 2, put a subtotal of all interest income listed on line 1. Below this subtotal, write "Tax-Exempt Interest" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and enter the result on line 2. Be sure to also show this tax-exempt interest on Form 1040, line 8b.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than tax exempt. Do not include such amount in tax-exempt interest.

Frozen deposits. If you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 1990, you can choose to exclude such amounts from your gross income (see *Interest income on frozen deposits* earlier under *Interest Income*). If you make this choice, do not include this income on line 8a. If you are completing Part I of Schedule B (Form 1040), include the full amount of interest shown on your Form 1099–INT on line 1. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write "Frozen Deposits" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2, Part I of Schedule B (Form 1040).

Nominee distributions and accrued interest. If the total interest income you list on line 1, Part I of Schedule B (Form 1040) includes any amount that you received as a nominee for the real owner, or that reflects accrued interest paid on a bond that you bought between interest payment dates, show such an amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distribution" or "Accrued Interest" as appropriate, and subtract it from the interest income subtotal. Report the result on line 2, Part I of Schedule B (Form 1040), and also on Form 1040, line 8a.

Interest on a joint account. If you receive a Form 1099–INT which shows your taxpayer identification number, and names two or more recipients or includes amounts belonging to another person, you must file a Form 1099–INT with the IRS to show the proper distributions of the amounts shown. Complete a Form 1099–INT and **Form 1096,** *Annual Summary and Transmittal of U.S. Information Returns,* and file both forms with your Internal Revenue Service Center. Give the other person(s) Copy B of the Form 1099–INT which you filed as a nominee. On Form 1099–INT and Form 1096, you should be listed as the "Payer." Prepare one Form 1099–INT for each other owner and show that person as the "Recipient." You are not required, however, to file Form 1099–INT to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see *1990 Instructions for Forms 1099, 1098, 5498, and W2-G.*

Example. You receive a Form 1099–INT for 1990 that shows a total of $1,500 of interest income earned on a savings account that you hold jointly with your sister. You each have agreed to share the yearly interest income in proportion to the amount that each of you has invested, even though your identification (social security) number was submitted to the bank for its recordkeeping purposes. Your sister has deposited 30% of the amount invested in this account. As a result, you are considered to be a nominee on behalf of the amount of interest income belonging to your sister. For 1990, this amount is $450, or 30% of the total interest of $1,500.

You must provide your sister with a Form 1099–INT no later than January 31, 1991, showing $450 of interest income that she earned for 1990. You must also send a copy of the nominee Form 1099–INT, along with Form 1096, to the Internal Revenue Service Center no later than February 28, 1991. Show your own name, address, and identification number as that of the "Payer" on the Form 1099–INT. Provide the same information for your sister in the blocks provided for identification of the "Recipient."

When you prepare your own 1990 federal income tax return, report the total amount of interest income, $1,500, on line 1, Part I of Schedule B (Form 1040), and identify the name of the bank which paid this interest. Show the amount belonging to your sister, $450, as a subtraction from a subtotal of all interest on Schedule B and identify this subtraction as a "Nominee Distribution."(Your sister will report the $450 of interest income on her own tax return, if she is required to file a return, and identify you as the payer of that amount.)

Original issue discount (OID). If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID, or other written statement (such as for a REMIC regular interest), include the full amount of OID shown on your Form 1099–OID or other statement on line 1, Part I of Schedule B (Form 1040). If the OID to be reported is less than the amount shown on Form 1099–OID, follow the above reporting rules for nominee distributions or accrued interest, as applicable, so that you will report only the OID you are required to report. Below the subtotal write "OID Adjustment" and show the OID you are not required to report. If the OID to be reported is greater than the amount shown on Form 1099–OID, show the additional OID separately below a subtotal of all interest income listed. Identify the amount as "OID Adjustment" and add it to the interest income subtotal.

Market discount. Report as interest any gain on the sale (or other disposition) of certain market discount bonds, to the extent of the accrued market discount. See *Market Discount Bonds*, earlier.

Penalty on early withdrawal of savings. If you withdraw funds from a time-savings account before maturity, you may be charged a penalty. You must report the gross amount of interest paid or credited to your account during the year, without subtracting the penalty. You deduct the penalty on line 28, Form 1040. Deduct the entire penalty even if it exceeds your interest income. The Form 1099–INT or similar statement given to you by the financial institution will show the gross amount of interest and the penalty.

Dividends and Other Corporate Distributions

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. (See *Dividends that are actually interest* under *Taxable Interest*, earlier.)

You may receive any of the following kinds of distributions:

Ordinary dividends
Capital gain distributions
Nontaxable distributions

Most distributions that you receive are paid in cash (check). However, you may receive additional stock, stock rights, other property, or services.

Form 1099–DIV. Most corporations use Form 1099–DIV, *Statement for Recipients of Dividends and Distributions*, to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099–DIV, you must report all of your taxable dividend income.

Nominees. If someone receives distributions as a nominee for you, that person will give you a Form 1099–DIV, which will show distributions they received on your behalf.

If you receive a Form 1099–DIV that includes amounts belonging to another person, see *Nominees*, later, under *How to Report Dividend Income*, for more information.

Form 1099–MISC. Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099–MISC, *Statement for Recipients of Miscellaneous Income*, or a similar statement. See also *Reporting substitute payments* under *Short Sales*, later in this publication.

Incorrect amount shown on a Form 1099. If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked "CORRECTED."

Dividends received in January. If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend) in October, November, or December and that dividend is payable to you on a specified date in such month, you are considered to have received the dividend on December 31 even though the company or trust actually pays the dividend during January of the following calendar year. Therefore, you report the amount in the year of declaration.

Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend, unless the paying corporation tells you otherwise.

Money market funds. Report amounts you receive from money market funds as dividend income. These amounts generally are not interest income and should not be reported as interest.

Dividends on capital stock. Dividends on the capital stock of organizations, such as savings and loan associations, are ordinary dividends. They are not interest. You should report them with your dividend income.

Dividends used to buy more stock. The corporation in which you own stock may have a ***dividend reinvestment plan.*** This plan lets you choose to use your dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you buy the stock at a price equal to the fair market value of the stock, you must report the cash dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy the stock at a price less than the fair market value of the stock, you must report as income the fair market value of the stock on the dividend payment date. You also must report as income any service charge subtracted from your cash dividends before the dividends are used to buy the stock. But you may be able to deduct the service charge. See *Expenses of Producing Income*, later.

In some dividend reinvestment plans, you can invest additional cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

Public utility stock reinvestment plans. If you own stock in a qualified domestic public utility and chose to receive your dividends in common stock, rather than in cash, you must include in your gross income the total value of such stock dividends.

Pre-1986 stock dividend exclusion. A stock dividend exclusion for reinvestment in public utility stock was allowable for distributions of such stock dividends (in lieu of cash dividends) that were made after 1981 and before 1986.

If you chose to exclude the value of the stock dividend from income before 1986, you were required to exclude it on your return for the year in which you would have included the dividends in income. If you decide to change your choice, you may do so only with the permission of the IRS.

If you excluded the value of the stock dividend from income, your basis in that stock is zero.

Capital Gain Distributions

Capital gain distributions or dividends are paid to you or credited to your account by regulated investment companies, mutual funds, and real estate investment trusts. Such distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income (defined later under *Investment Expenses*) and are not considered as income from a passive activity.

Regulated investment companies and mutual funds. You will receive a Form 1099–DIV or similar statement from the regulated investment company or mutual fund showing the capital gain distributions paid or credited to you during the year. See Publication 564, *Mutual Fund Distributions*, for more information on the treatment of these distributions.

You report as long-term capital gains the capital gain distributions paid to you during the year regardless of how long you owned the stock in the regulated investment company or mutual fund.

For information about reporting investment expenses that are allocated to you by the regulated investment company or mutual fund, see *How to Report Investment Expenses*, later in this publication.

Undistributed capital gains. In addition to the amounts you receive, you must report as long-term capital gains any amounts that the investment company or mutual fund credited to you as capital gain distributions, even though you did not actually receive them. (This income is not reported to you on Form 1099–DIV.)

Form 2439. You can take a credit on your return for any tax that the investment company or mutual fund has paid for you on the undistributed capital gains. The company or fund will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*, showing the amount of the undistributed long-term capital gain and the tax that was paid.

You take the credit by entering the tax paid on line 61, Form 1040. You must attach Copy B of Form 2439 to your return.

Basis adjustment. Increase your basis in the stock by the difference between the amount of undistributed long-term capital gain that you report and the amount of the tax paid for you by the fund. Keep Copy C of Form 2439 as part of your records to show increases in the basis of your stock.

Note: You must report any undistributed gains shown on Form 2439 in addition to any capital gain distributions reported on Form 1099–DIV.

Loss on sale of stock. If you received, or were considered to have received, capital gain distributions on mutual fund stock that you held for 6 months or less and sold at a loss, you must report as a long-term capital loss the part of the loss that is equal to, or less than, the capital gain distribution. There is an exception for losses incurred under a periodic liquidation plan.

Example. On April 22, you bought a share of stock in a mutual fund for $20. On June 30, the mutual fund declared a capital gain dividend of $2 a share, which is taxed as a long-term capital gain. On July 7, you sold the share of stock for $17.50. You must report $2 of the loss as a long-term capital loss. The other 50 cents of the loss is a short-term capital loss.

Real estate investment trusts (REITs). You will receive a Form 1099–DIV or similar statement from the REIT showing the capital gain distributions you must include in your income. You report the capital gain distribution as long-term capital gain regardless of how long you owned stock in the REIT.

Loss on stock. If you received a capital gain distribution on REIT stock that you held for 6 months or less and sold at a loss, you must report as a long-term capital loss the part of the loss that is equal to, or less than, the capital gain distribution. This rule does not apply to dispositions of stock under a periodic liquidation plan.

Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of additional shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of capital. A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV or other statement from the corporation showing you what part of the distribution is a return of capital. If you do not receive such a statement, you report the distribution as an ordinary dividend.

A return of capital reduces the basis of your stock and is not taxed until your basis in the stock is fully recovered. When the basis of your stock has been reduced to zero, report any return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period,* later.

Example. You bought stock in 1985 for $100. In 1987, you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of your stock. Your stock now has an adjusted basis of $20. You receive a return of capital of $30 in 1990. You use $20 of this amount to reduce your basis to zero. You report the other $10 as a long-term capital gain for 1990. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating distributions. Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive Form 1099–DIV from the corporation showing you the amount of the liquidating distribution.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain (except in certain instances with regard to collapsible corporations). Whether you report the gain as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period,* later.

If you acquired stock in a corporation at several different times, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the following proportion: the number of shares in that block over the total number of shares you own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.

If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You may report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock. See *Holding Period* later.

Distributions of stock and stock rights. Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

Taxable stock dividends and stock rights. Distributions of stock dividends and stock rights are taxable to you if:

1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights,
2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders,
3) The distribution is in convertible preferred stock and has the same result as in (2),
4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders, or
5) The distribution is on preferred stock. (This requirement, however, does not apply if the distribution is made for convertible preferred stock solely to take into account a stock dividend, stock split, or a similar event that would otherwise result in reducing the conversion right.)

In addition, any transaction having the effect of increasing your proportionate interest in the corporation's assets or earnings and profits may be taxable to you, even though no stock or stock rights are actually distributed.

Basis. If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income. This amount is your basis in the stock or stock rights received. If you receive stock dividends or stock rights that are not taxable to you, see *Stocks and Bonds* under *Basis of Investment Property,* later, for information on how to figure the basis of the stock dividends or stock rights you receive.

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which no fractional shares are issued, but are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

Example. You own one share of common stock that you bought on January 3, 1989, for $100. The corporation declared a common stock dividend of 5% on June 30, 1990. The fair market value of the stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend ($200 ÷ $210 × $100)	$ 95.24
Basis (cost) of stock dividend ($10 ÷ $210 × $100)	4.76
Total	$100.00
Cash received	$ 10.00
Basis (cost) of stock dividend	4.76
Gain	$ 5.24

Because you had held the share of stock more than one year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

Other Distributions

You may receive any of the following distributions during the year.

Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement,* next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

Information-reporting requirement. Although these dividends are not taxable, you must show them on your tax return if you are required to file a return. This is an information-reporting requirement and does not convert tax-exempt interest to taxable interest. See *How to Report Interest Income,* earlier. Also, exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a "tax preference item" that may be subject to the alternative minimum tax. See Publication 909 for more information.

Loss on sale of stock. If you received exempt-interest dividends on mutual fund stock that you held for 6 months or less and sold at a loss, you cannot claim the part of the loss that is equal to or less than the exempt-interest dividends. You must report the balance of the loss as a short-term capital loss. There is an exception for losses incurred under a periodic liquidation plan.

Dividends on insurance policies are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. However, you must report as taxable income the interest that is paid or credited on dividends left with the insurance company.

Dividends on veterans' insurance are not taxable. However, you must report as taxable income interest on dividends left with the Department of Veterans Affairs.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

1) Property bought for your personal use, or
2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund Dividends. Do not report these amounts as dividends. Instead, report these amounts on line 22 of Form 1040.

How to Report Dividend Income

Generally, you may use either Form 1040 or Form 1040A to report your dividend income. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions. If you receive any dividend income, you may not use Form 1040EZ.

Form 1099–DIV. If you owned stock on which you received more than $10 gross dividends and other distributions, you should receive a Form 1099–DIV.

Box 1a of Form 1099–DIV shows the amount of gross dividends and other distributions you received on stock.

Box 1b of Form 1099–DIV shows your ordinary dividends. This amount is included in Box 1a. If you do not need to file Schedule B (Form 1040), or Schedule 1 (Form 1040A), enter the amount shown in Box 1b and any investment expenses from Box 1e on line 9 (Form 1040 or Form 1040A).

Box 1c of Form 1099–DIV shows your capital gain distributions. You report these capital gains on line 5 of Schedule B (Form 1040). You cannot file Form 1040A. Since these capital gains are included in the amount shown in Box 1a of Form 1099–DIV, they are entered on line 5 of Schedule B and subtracted out on line 7 of Schedule B. These capital gains are also reported on either Schedule D (Form 1040), Part II, line 13 or, if you do not need to complete Schedule D, report them directly on line 14 of Form 1040.

Box 1d of Form 1099–DIV shows your nontaxable distributions. Since this amount is included in Box 1a of Form 1099–DIV, it is entered on line 5 of Schedule B and subtracted out on line 8 of Schedule B. Amounts shown are usually a return of capital that reduces your basis in the stock. Once you have received an amount equal to your cost or other basis, these distributions are taxable to you as a capital gain even if the payer lists them as nontaxable.

If you own stock in a nonpublicly-offered regulated investment company, your pro rata share of that fund's allocable investment expenses is shown in Box 1e of Form 1099–DIV. This amount is also included in Box 1a of Form 1099–DIV. You can deduct these expenses as a miscellaneous itemized deduction subject to the 2% of adjusted gross income limit only if you itemize on Schedule A (Form 1040).

If you were subject to backup withholding, because, for example, you failed to furnish your social security number to a payer, the amount withheld will be shown as "Federal income tax withheld" in Box 2 of Form 1099–DIV. Report this amount on Form 1040A, line 28a, or on Form 1040, line 55.

Box 3 of Form 1099–DIV shows the amount of foreign taxes withheld (paid) on dividends and other distributions, and Box 4 identifies the foreign country or U.S. possession. If there are entries in these boxes, fill out Form 1040 and **Form 1116.** However, do not complete Form 1116 if you claim this amount as other taxes on Schedule A. For more information on the credit and deduction, see Publication 514.

Box 5 of Form 1099–DIV shows distributions of cash from corporations in partial or complete liquidation. Box 6 shows the fair market value of noncash distributions. If there are entries in these boxes, see *Liquidating distributions*, earlier under *Nontaxable Distributions.*

Dividends received on restricted stock. Restricted stock is stock that you get from your employer for services you perform and that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on restricted stock, you must include them in your income as wages, not dividends. See *Restricted Property Received for Services* in Publication 525, *Taxable and Nontaxable Income,* for information on restricted stock dividends.

Your employer should include these dividends in the wages shown on your Form W–2. If you also get a Form 1099–DIV for these dividends, list them on line 5, Part II of Schedule B (Form 1040), with the other dividends you received. Enter a subtotal of all your dividend income several lines above line 6. Below the subtotal, write "Dividends on restricted stock reported as wages on line 7, Form 1040," and enter the amount of the dividends included in your wages on line 7, Form 1040. Subtract this amount from the subtotal and enter the result on line 6, Part II of Schedule B.

Election. You can elect to include in gross income an amount of restricted stock as compensation for services. If you make this choice, the dividends are treated as any other dividends. Report them on line 9, Form 1040, or line 9, Form 1040A. If you receive both a Form 1099–DIV and a Form W–2 showing these dividends, do not include the dividends in your wages reported on line 7, Form 1040. List the dividends on line 5, Part II of Schedule B, along with your other dividends. Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W–2.

Dividends on stock sold. If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must report the dividend. Even if the purchase price of the stock goes up because of the amount of the anticipated dividend, the owner of record must report such dividend.

Stock sold short. If you borrow stock to make a short sale (see *Short Sales,* later), you may have to pay the lender an amount in lieu of the dividends distributed while you maintain your short position. Your treatment of the payment depends on the kind of distribution for which you are reimbursing the lender of the stock.

If your payment is made for a liquidating distribution or nontaxable stock distribution, or if you buy more shares equal to a stock distribution issued on the borrowed stock during your short position, you have a capital expense. You must add the payment to the cost of the stock sold short.

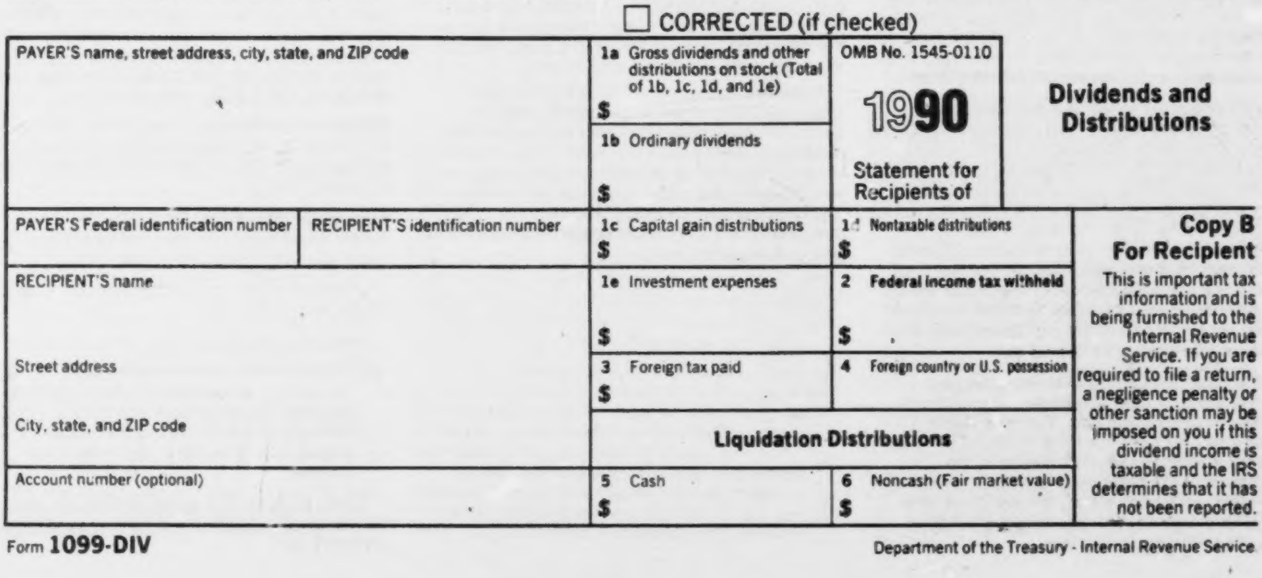
For more information, see *Short sale expenses,* later under *Short Sales.*

Form 1040A

Report your total dividends on line 9, Form 1040A. If the amount on line 9 is more than $400, you also must list each payer's name and the amount of dividends received from each payer in Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A. If you received a Form 1099–DIV from a brokerage firm, list the brokerage firm as the payer. However, you must use Form 1040 instead of Form 1040A if you had capital gain distributions or return of capital distributions. (Exempt-interest dividends, which are treated as interest, should be reported on line 8b. See *How to Report Interest Income,* earlier.)

Nominees. If you received dividends as a nominee (that is, the dividends are in your name but actually belong to someone else), include them on line 5 of Schedule 1. Several lines above line 6, put a subtotal of all dividend income listed on line 5. Below this subtotal, write "Nominee Distributions" and show the amounts received as a nominee. Subtract the total of your nominee distributions from the subtotal. Enter the result on line 6 of Part II.

See *Nominees* later for more information.



☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code		**1a** Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 **1990** Statement for Recipients of	**Dividends and Distributions**
		1b Ordinary dividends $		
PAYER'S Federal identification number	RECIPIENT'S identification number	**1c** Capital gain distributions $	**1d** Nontaxable distributions $	**Copy B For Recipient** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this dividend income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name		**1e** Investment expenses $	**2** Federal income tax withheld $	
Street address		**3** Foreign tax paid $	**4** Foreign country or U.S. possession	
City, state, and ZIP code		**Liquidation Distributions**		
Account number (optional)		**5** Cash $	**6** Noncash (Fair market value) $	

Form **1099-DIV** Department of the Treasury - Internal Revenue Service

Form 1040—Total Dividends and Other Distributions of $400 or Less

If your total dividends, including capital gain and nontaxable distributions, are $400 or less, report only the total of your ordinary dividends from Box 1b of Form 1099–DIV and any investment expenses from Box 1e of Form 1099–DIV on line 9, Form 1040.

Capital gain distributions. Report capital gain distributions (Box 1c of Form 1099–DIV) on line 13, Part II of Schedule D (Form 1040). If you do not need Schedule D to report any other capital gains or losses, enter your capital gain distributions on line 14, Form 1040.

Nontaxable (return of capital) distributions. Some distributions are nontaxable because they are a return of your cost. You report return of capital distributions (Box 1d of Form 1099–DIV) only when your basis in the stock has been reduced to zero. If the basis of your stock is zero, report any return of capital distribution you receive on line 2d, Part I of Schedule D, if you have held the stock one year or less, or on line 9d, Part II of Schedule D, if you have held the stock for more than one year.

Form 1040—Total Dividends and Other Distributions of More Than $400

If your total dividends, including capital gain and nontaxable distributions, are more than $400, you must fill in Schedule B and attach it to your return. You must complete Parts II and III of Schedule B.

You must report all of your dividend income (Box 1a of Form 1099–DIV) on line 5, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions you receive. You should list the name of the payer and the amount of income for each distribution you receive. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099–DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credits or pays you dividends on the stock, you should show the name of the nominee and the dividends you received or for which you were credited. You should enter on line 6 the total of the amounts listed on line 5. However, if you hold stock as a nominee, see *Nominees,* later.

Capital gain distributions. You enter on line 7, Part II of Schedule B, any amount shown on line 5 that is a capital gain distribution. You also enter this amount on line 13, Part II of Schedule D (Form 1040). If you do not need to use Schedule D to report any other gains or losses, do not use it. Instead, show your capital gain distributions on line 14, Form 1040.

Nontaxable (return of capital) distributions. You enter on line 8, Part II of Schedule B, any amount from line 5 that you received as a return of capital distribution. However, after the basis of your stock has been reduced to zero, you must also show this amount on line 2d, Part I of Schedule D, if you held the stock one year or less, or on line 9d, Part II of Schedule D, if you held the stock for more than one year.

Completing Schedule B. Add the amounts shown on lines 7 and 8 and enter the total on line 9. Subtract the amount on line 9 from the amount on line 6. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 10, Part II of Schedule B, and on line 9, Form 1040. You must also complete Part III of Schedule B.

Nominees. Include on line 5, Part II of Schedule B (Form 1040), all dividends you received. This includes dividends you received, as a nominee, that actually belong to another person (such as your child), even if you later distributed some or all of this income to others. Enter a subtotal of all your dividend income listed on line 5 several lines above line 6. Below the subtotal, write "Nominee Distribution" and show the amounts received as a nominee. Subtract these distributions from the subtotal and enter the result on line 6.

If you receive a Form 1099–DIV on which your taxpayer identification number is shown, and two or more recipients are named, or amounts belonging to another person are included, you must file a Form 1099–DIV with the IRS to show the proper distributions of these amounts. Complete a **Form 1096,** *Annual Summary and Transmittal of U.S. Information Returns,* and file both forms with the Internal Revenue Service Center. Give the other person Copy B of the Form 1099–DIV which you filed as a nominee. On Form 1099–DIV and Form 1096, you should be listed as the "Payer." On Form 1099–DIV, the other owner should be listed as the "Recipient." You are not required, however, to file a Form 1099–DIV to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see *1990 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Liquidating distributions. You will receive Form 1099–DIV from the corporation showing the amount of the liquidating distribution. Generally, this is treated as the sale or exchange of a capital asset and should be reported on Schedule D (Form 1040).

Real Estate Mortgage Investment Conduits (REMICs) and Other Collateralized Debt Obligations (CDOs)

Holders of interests in real estate mortgage investment conduits (REMICs) and other collateralized debt obligations (CDOs) must follow special rules for reporting income and any expenses from these investment products.

REMICs

A ***real estate mortgage investment conduit (REMIC)*** is an entity that is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. A REMIC issues to investors regular and residual interests. For tax purposes, a REMIC is generally treated as a partnership with the residual interest holders treated as the partners. The regular interests are treated as debt instruments.

Amounts includible in income (or deductible as a loss) by holders of REMIC regular and residual interests are treated as portfolio income (or loss). Such income (or loss) is not taken into account in determining the loss from a passive activity. For more information about the qualifications and the tax treatment that apply to a REMIC and the interests of investors in a REMIC, refer to Sections 860A through 860G of the Internal Revenue Code, and regulations issued thereunder.

Regular interest defined. A regular interest is treated as a debt instrument for all federal tax purposes. A REMIC may have several classes (also known as "tranches") of regular interests. A regular interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount). Any interest payments must be payable based upon a fixed or variable rate, or they must consist of a specified portion of the interest payments on qualified mortgages. This specified portion may not vary during the period in which such interest is outstanding. The timing (but not the amount) of principal payments may be contingent on the extent of prepayments on qualified mortgages and the amount of income from permitted investments of a REMIC.

Tax treatment of REMIC regular interests. A REMIC regular interest is treated as a debt instrument for income tax purposes. Accordingly, the OID, market discount, and income-reporting rules that apply to bonds and other debt instruments as described earlier in this publication under *Discount on Debt Instruments,* apply, with certain modifications discussed below.

Reporting requirements. When you figure your income on your tax return, you must include in income accrued interest and OID that accrued during the tax year on your regular interest. Holders of regular interests must use the accrual method of accounting to report OID and interest income. Because the accrual method is not based on the receipt of cash, you may have to include OID or interest income in your taxable income even if you have not received any cash payments.

Forms 1099–INT and 1099–OID. You should receive a copy of Form 1099–INT, or Form 1099–OID and an additional written statement, that indicates the amounts you must include in your gross income before March 16, 1991 (if you are a calendar year taxpayer). The additional written statement should also contain enough information to enable you to figure your accrual of market discount or amortizable bond premium.

Form 1099–INT shows the amount of interest income that accrued to you for the period you held the regular interest.

Form 1099–OID shows the amount of OID and interest, if any, that accrued to you for the period you held the regular interest. You will not need to make any adjustments to the amounts reported even if you held the regular interest for only a portion of the calendar year.

Generally, you report your income from a regular interest on line 8a, Form 1040. For more information on how to report OID, see *Original issue discount (OID),* under *How to Report Interest Income,* earlier.

Persons exempt from Form 1099 reporting. Corporations, fiscal year taxpayers, and other persons specified in Regulation 1.6049-7T(c)(7) through (14) will not receive Forms 1099. They may obtain tax information by contacting the REMIC or the issuer of the CDO, if they hold directly from the REMIC or issuer of the CDO. Publication 938, *Real Estate Mortgage Investment Conduits (REMICs) Reporting Information,* should be used to request the information in the manner prescribed in Regulation 1.6049-7T(e)(5). If the specified exempt recipient holds the regular interest or CDO through a nominee (rather than directly), they can request the information from their nominee in the manner prescribed in Regulation 1.6049-7T(f)(7)(i).

Allocated investment expenses of a REMIC. Regular interest holders in a REMIC may be allowed to deduct certain miscellaneous expenses, but ***only*** if the REMIC is a ***single-class*** REMIC. A single-class REMIC is one that generally would be classified as a trust for tax purposes if it had not elected REMIC status.

The single-class REMIC will report your share of allocated investment expenses as interest income in Box 2 of Form 1099-OID, or on the additional written statement.

You may be able to take a deduction for these expenses subject to a ***2% limit*** that also applies to certain other miscellaneous itemized deductions. See *Investment Expenses* later, for more information.

Redemption of REMIC regular interests at maturity. Redemption of debt instruments at their maturity is treated as a sale or exchange. You must report redemptions on your tax return (Schedule D of Form 1040 for individuals) whether or not you realize gain or loss on the transaction. Your basis is your adjusted issue price, which includes any OID you included in income.

Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument. A debt instrument is retired when it is reacquired or redeemed by the issuer and canceled.

Sale or exchange of a REMIC regular interest. Gain on the sale or exchange of a REMIC regular interest will be ordinary income to the extent of the excess, if any, of:

- The amount that would have been included in your income if the yield to maturity on the regular interest had been 110% of the applicable Federal rate at the beginning of your holding period, over
- The amount you included in your income.

Residual Interest Holder

A residual interest is an interest in a REMIC that is not a regular interest. It is designated as a residual interest by the REMIC.

Tax treatment of REMIC residual interests. If you acquire a residual interest in a REMIC, you must take into account, on a quarterly basis, your daily portion of the taxable income or net loss of the REMIC for each day during the tax year that you hold the residual interest. You must report such amounts as ordinary income or loss.

Excess inclusions. A portion of the REMIC's taxable income allocated to you may be characterized as an ***excess inclusion.*** Your taxable income for the calendar year cannot be less than your allocable share of the amount of the excess inclusion for that calendar year.

Limit on recognition of losses. You may not claim your share of the quarterly net loss from a REMIC that is greater than the adjusted basis of your residual interest in the REMIC at the end of the calendar quarter (determined without regard to your share of the net loss of the REMIC for that quarter). You may treat the amount disallowed as a loss incurred by the REMIC in the next calendar quarter, but only for the purpose of offsetting your share of REMIC taxable income for that quarter.

Basis in the residual interest. Your basis in the residual interest is increased by the amount of taxable income you take into account. Your basis is decreased (but not below zero) by the amount of cash or the fair market value of any property distributed to you, and by the amount of any net loss you have taken into account. If you sell your residual interest, you must adjust your basis to reflect your share of the REMIC's taxable income or net loss immediately before such sale. See also *Wash Sales*, later, for additional information about selling a residual interest.

Treatment of distributions. You must include in your gross income any distribution that exceeds your adjusted basis and treat such distribution as a gain from the sale or exchange of your residual interest.

Schedule Q. If you hold a REMIC residual interest, you should receive Schedule Q (Form 1066), *Quarterly Notice to Residual Interest Holder of REMIC Taxable Income or Net Loss Allocation*, and instructions from the REMIC each quarter. Schedule Q will indicate your pro rata share of the REMIC's quarterly taxable income (or loss), any excess inclusion to be included in your income, your pro rata share of the REMIC's expenses for the quarter, and other information that is relevant only to certain institutional investors.

Do not attach Schedules Q to your tax return. Keep them for your records.

Use Part IV of Schedule E (Form 1040) to report your total share of the REMIC's taxable income (or loss) for each quarter included in your tax year. Generally, you must report REMIC items shown on Schedule Q (and any attached schedules), or similar statement, consistent with the way the REMIC treated the items on the return it filed. If you are treating these REMIC items differently from the REMIC, you must complete **Form 8082,** *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)),* and attach it to your tax return.

For more information about reporting your income (or loss) from a residual interest in a REMIC, follow the Schedule Q (Form 1066) and Schedule E (Form 1040) instructions.

Expenses. Subject to the 2% of adjusted gross income limit, you may be able to claim a miscellaneous itemized deduction on your tax return for certain ordinary and necessary expenses that you paid or incurred, directly or indirectly, in connection with your investment in a REMIC. Indirect expenses may include certain expense items incurred by the REMIC and passed through to the investor. See *Investment Expenses*, later, for information about how to report such income and expenses.

Collateralized Debt Obligations (CDOs)

A ***collateralized debt obligation (CDO)*** is a debt instrument, other than a REMIC regular interest, that is secured by a pool of mortgages or other evidence of debt and that has principal payments that are subject to acceleration. (Note: While REMICs are collateralized debt obligations, they have unique rules that do not apply to CDOs issued before 1987.) CDOs, also known as "pay-through bonds," are commonly divided into different classes (also called "tranches").

CDOs can be secured by a pool of mortgages, automobile loans, equipment leases, or credit card receivables.

For more information about the qualifications and the tax treatment that apply to an issuer of a CDO, refer to Section 1272(a)(6) of the Internal Revenue Code, and any regulations issued thereunder.

Tax treatment of CDOs. If you are the holder of a CDO, that obligation is considered to be a debt instrument for income tax purposes. Accordingly, the OID, market discount, and income-reporting rules that apply to bonds and other debt instruments, as described earlier in this publication under *Discount on Debt Instruments*, also apply to you with certain modifications as discussed in this section.

Reporting requirements. When you figure your income on your tax return, you must include interest income you actually received under the cash method of accounting and any accrued OID on your CDO during the tax year.

Forms 1099–INT and 1099–OID. You should receive a copy of Form 1099–INT, or Form 1099–OID and an additional written statement, before March 16, 1991 (if you are a calendar year taxpayer), that indicates the amounts you must include in your gross income. The additional written statement should contain enough information about the CDO to enable you to figure your accrual of market discount or amortizable bond premium.

Generally, you report your income from a CDO on line 8a, Form 1040. For more information about reporting these amounts on your return, see *Original issue discount (OID),* under *How to Report Interest Income,* earlier.

Form 1099–INT shows the amount of interest income paid to you for the period you held the CDO.

Form 1099–OID shows the amount of OID accrued to you and the interest, if any, paid to you for the period you held the CDO. You should not need to make any adjustments to the amounts reported even if you held the CDO for only a portion of the calendar year.

Persons exempt from Form 1099 reporting should see *Persons exempt from Form 1099 reporting* earlier under *REMICs.*

Acquisition Premium

If you bought the debt instrument after its startup date or issue date, the amount of OID shown on Form 1099–OID, or the accompanying additional written statement, may not be the proper amount for you to include in income. For example, if you bought the debt instrument for more than the original issue price plus the amount of accumulated OID from the startup day of the REMIC (issue date for a CDO), that excess (or ***acquisition premium***) reduces the amount of OID includible in your income. To determine the amount to subtract from your OID, use the formula described below.

Computation of acquisition premium. Multiply the daily portion of OID by a fraction in which:

1) The numerator is the acquisition premium you paid for the instrument on the purchase date; and
2) The denominator is the total amount of OID remaining for such instrument after your purchase date and ending on the stated maturity date.

S Corporations

To qualify for S corporation status, a corporation must be a domestic corporation with only one class of stock. It cannot be a member of an affiliated group of corporations. It must not have more than 35 shareholders. Only individuals or their estates or a qualifying trust can be shareholders. A shareholder cannot be a nonresident alien. When counting shareholders, a husband and wife and their estates are treated as one shareholder. All shareholders must agree to the corporation's decision to be an S corporation.

In general, an S corporation does not pay a tax on its income. Instead, its income and expenses are passed through to the shareholders, who then report these items on their own income tax returns.

An S corporation must file a return on **Form 1120S,** *U.S. Income Tax Return for an S Corporation.* This shows the results of the corporation's operation for its tax year and the items of income, gain, loss, deduction, or credit that affect the shareholders' individual income tax returns.

Generally, S corporation distributions are a nontaxable return of your basis in the corporation's stock. However, in certain cases, part of the distributions may be taxable as a dividend, or as a long-term or short-term capital gain, or as both. The corporation's distributions may be in the form of cash or property.

All current year income or loss and other tax items are taxed to you at the corporation's year end (generally, the end of the calendar year) whether or not you actually receive any amount. Generally, those items increase or decrease the basis of your S corporation stock as appropriate. Dividends of an S corporation generally are only paid from retained earnings from years prior to 1983 or prior to becoming an S corporation. Generally, property (including cash) distributions, except dividend distributions, are considered a return of capital and reduce your basis in the stock of the corporation. Distributions in excess of basis are treated as a gain from the sale or exchange of property. For more information on basis adjustments, see *S corporation stock* under *Basis of Investment Property*, later.

How to report S corporation income, deductions, and credits. The S corporation should send you a copy of Schedule K-1 (Form 1120S) showing your share of income, credits, and deductions of the S corporation for the tax year. Your distributive share of the items of income, gain, loss, deduction, or credit of the S corporation must be reported on the appropriate lines and schedules of your Form 1040. You generally treat these items as if you had realized or incurred them personally.

If you are treating S corporation items on your tax return differently from the way the S corporation reported the items on its return, you must complete **Form 8082,** *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)),* and attach it to your tax return. For more information about your treatment of the S corporation tax items, see *Shareholder's Instructions for Schedule K-1 (Form 1120S).*

For more information about S corporations, see Publication 589, *Tax Information on S Corporations.*

Passive activity losses. Rules apply that limit losses from passive activities. Your copy of Schedule K-1 and its instructions will explain the limits and tell you where on your return to report your share of S corporation items from passive activities.

Form 8582. If you have a passive activity loss from an S corporation, you must complete Form 8582, *Passive Activity Loss Limitations,* to figure the amount of the allowable loss to enter on your return. See Publication 925 for more information.

Investment Clubs

An investment club is formed when a group of friends, neighbors, business associates, or others pool limited or stated amounts of funds to invest in stock or other securities. The club may or may not have a written agreement, a charter, or bylaws.

Usually the group operates informally with members pledging to pay a regular amount into the club monthly. Some clubs have a committee that gathers information on securities, selects the most promising securities, and recommends that the club invest in them. Other clubs rotate the investigatory responsibilities among all their members. Most clubs require all members to vote for or against all investments, sales, exchanges, and other transactions.

Many clubs operate as partnerships and are treated as such for federal tax purposes. Others operate as corporations, trusts, or associations that are taxed as corporations.

Tax returns and identifying numbers. Investment clubs must file either **Form 1065,** *U.S. Partnership Return of Income;* **Form 1041,** *U.S. Fiduciary Income Tax Return;* or **Form 1120,** *U.S. Corporation Income Tax Return.* Certain small corporations may be able to file **Form 1120-A,** *U.S. Corporation Short-Form Income Tax Return.* See the *Instructions for Forms 1120 and 1120-A.*

Form SS-4. Each club must have an employer identification number (EIN) to use when filing their return. The club's EIN also may have to be given to the payer of dividends. If your club does not have an EIN, get Form SS-4, *Application for Employer Identification Number,* from the IRS or from your nearest Social Security Administration office. Mail the completed Form SS-4 to the Internal Revenue Service Center where you file the club's tax return.

When stock is recorded in the name of the investment club, the club must give its own EIN to the payer of dividends.

If the club is a partnership or a trust, the dividends distributed to the partners or beneficiaries must be shown on Form 1065 or Form 1041, respectively. The partners' or the beneficiaries' identifying numbers also must be shown on the return.

If the club is an association taxed as a corporation, any distribution it makes that qualifies as a dividend must be reported on Forms 1096 and 1099-DIV if total distributions to the shareholder are $10 or more for the year.

When stock is recorded in the name of one club member, this member must give his or her social security number to the payer of dividends. (When stock is held in the names of two or more club members, the social security number of only one member must be given to the payer.) This member is considered as the record owner for the actual owner of the stock, the investment club. This member is a "nominee" and must file Form 1099-DIV, showing the club to be the owner of the dividend, his or her social security number, and the EIN of the club.

The club as an association or corporation. Your investment club must file a Form 1120 (or Form 1120-A) and be taxed as a corporation if it is incorporated, or if it is an association that must be treated as a corporation. If your investment club is unincorporated, to be treated as a corporation for tax purposes, it must have associates, be organized to carry on business, and divide the gains from the business. In addition, the organization must have a majority of the following characteristics:

1) Continuity of life,
2) Centralization of management,
3) Limited liability, and
4) Free transferability of interests.

The presence or absence of these characteristics must be taken into account in determining whether an organization is an association. The facts in each case determine whether or not the characteristics are present.

Other factors can also be significant in classifying an organization as an association. An organization will be treated as an association if the corporate characteristics are such that it more nearly resembles a corporation than a partnership or trust. Certain publicly-traded partnerships are also treated as corporations.

If your club must file Form 1120 (or Form 1120-A), you do not report any of its income or expenses on your individual return. All ordinary income and expenses and capital gains and losses must be reported on the Form 1120 (or Form 1120-A). However, you must report any distributions that you receive from the corporation.

Some corporations can choose not to be taxed and have earnings taxed to the shareholders. See *S Corporations,* earlier.

For more information about corporations, see Publication 542, *Tax Information on Corporations.*

Passive activity losses. Except for certain closely held and personal service corporations, the rules that limit losses from passive activities do not apply to corporations.

The club as a partnership. If your club is not a corporation or an association taxed as a corporation, it will be treated as a partnership. A partnership is an unincorporated organization through which any business, financial operation or venture operates. It includes syndicates, groups, pools, and joint ventures.

Example. You and 24 other persons each agree to contribute $10 a month to jointly invest in securities. All of you are to share the income from such investments equally.

While the agreement states that your club will operate until it is ended by a three-fourths vote of the total membership and that it will not end on the withdrawal or death of any member, under local law any member has the power to dissolve the club at any time.

The business of your club is conducted by the members at regular monthly meetings. Buy or sell action may be taken only when voted by a majority of the club's membership present. Elected officers perform only administrative functions, such as presiding at meetings and carrying out the directions of the members. Members of the club are personally liable for all debts of, or claims against, the club. Neither you nor any other member may transfer membership.

Your club is made up of associates. Its objective is to carry on business and divide the gains from the business. However, the club does not have the corporate characteristics of limited liability, free transferability of interest, continuity of life, and centralized management. Therefore, your club will be treated as a partnership for federal tax purposes and must file a return on Form 1065.

If your investment club is treated as a partnership, you, as a partner in the club, must report your share of the club's income, gains, loss, deductions, and credits for the club's tax year. Its tax year generally must be the same tax year as that of the partners owning a majority interest. You must report these items whether or not you actually receive any distribution from the partnership.

Your share of partnership income or loss will fall into one or both of the following categories:

Partnership ordinary income or loss as figured on page 1 of Form 1065. You should receive a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.,* from the partnership. You report the income or loss shown on your Schedule K-1 (Form 1065) in Part II of Schedule E (Form 1040). See also *Passive activity losses,* later in this discussion.

Special items of partnership income, credits, deductions, etc., as shown on your Schedule K-1 (Form 1065). These items are entitled to special tax treatment. You enter your share of them, as shown on your Schedule K-1, on the appropriate lines and schedules of your income tax return.

Usually, in an investment club, the partnership's ordinary income consists only of taxable interest and dividends. Other items of income, such as long-term and short-term capital gains and losses, "Section 1231" gains and losses, and partially tax-exempt interest, are divided among the partners and reported separately by them.

The club's expenses for producing or collecting income, for managing investment property, or for determining any tax are also special items. They are listed separately on Schedule K-1 (Form 1065). These expenses are not used to figure partnership ordinary income, but can be deducted by the individual partners if they itemize their deductions on Schedule A (Form 1040). They are listed on line 21 of Schedule A with other miscellaneous deductions subject to the 2% limit. See *Investment Expenses,* later, for more information.

If you are treating partnership items on your tax return differently from the way the partnership reported the items on its return, you must complete **Form 8082,** *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)),* and attach it to your tax return. For more information about reporting your income from a partnership, follow the Schedule K-1 (Form 1065) instructions.

For more information about the tax treatment of partnership items and a partner's tax return, see Publication 541, *Tax Information on Partnerships.*

Passive activity losses. Rules apply that limit losses from passive activities. Your copy of Schedule K-1 (Form 1065) and its instructions will tell you where on your return to report your share of partnership items from passive activities. If you have a passive activity loss from a partnership, you must complete **Form 8582,** *Passive Activity Loss Limitations,* to figure the amount of the allowable loss to enter on your tax return.

Choice not to be treated as a partnership. An unincorporated club used only for investment purposes, and not for the active conduct of a business, can choose not to be treated as a partnership.

To make this choice, the club must file a partnership return, Form 1065, for the first year for which it does not want to be treated as a partnership. The return must be filed by the due date, including extensions, for filing the return. This return should show only the name or other identification and the address of the club. A separate statement must be attached to the return showing the following information:

1) The names, addresses, and identification numbers of all the members of the club,
2) A statement that the club is used for investment purposes only and that its members can figure their income without figuring partnership taxable income,
3) A statement that the club is an investing partnership,
4) Information about where the terms of the agreement, written or oral, under which the club operates, can be obtained, and
5) A statement that all the members of the club have chosen the exclusion from partnership treatment.

If the investment club makes this choice, Form 1065 need not be filed for later years, but the members must report their share of income, deductions, and credits on their individual Forms 1040. The members can deduct their share of investment expenses, as miscellaneous deductions subject to the 2% limit, on Schedule A (Form 1040) if they itemize their deductions. The choice remains in effect as long as the club qualifies, or until the IRS approves the club's application to change the choice.

No social security coverage for investment club earnings. If an investment club partnership's activities are limited to investing in savings certificates, stock, or securities, and collecting interest or dividends for its members' accounts, the members' share of income is not earnings from self-employment. You cannot voluntarily pay the self-employment tax in order to increase your social security coverage and ultimate benefits.

For more information on self-employment tax, see Publication 533, *Self-Employment Tax.*

SCHEDULE Q
(Form 1066)
(Rev. January 1990)
Department of the Treasury
Internal Revenue Service

Quarterly Notice to Residual Interest Holder of REMIC Taxable Income or Net Loss Allocation

For calendar quarter ended ...., 19 ....

(Complete for each residual holder—See instructions on back of Copy C.)

OMB No. 1545-1014
Expires 11-30-92

Copy B—For Residual Holder

Residual holder's identifying number

REMIC's identifying number

Residual holder's name, address, and ZIP code

REMIC's name, address, and ZIP code

A What type of entity is this residual holder? ► ....

B Enter residual holder's percentage of ownership of all residual interests:

(i) Before change: .... %

(ii) End of quarter: .... %

C Enter the percentage of the REMIC's assets for the quarter represented by each of the following:

(i) Qualifying real property loans under section 593 ► .... %

(ii) Real estate assets under section 856 ► .... %

(iii) Assets described in section 7701(a)(19)(C) (relating to the definition of a domestic building and loan association) ► .... %

D IRS Center where REMIC files return ►

E Reconciliation of residual holder's capital account:

(a) Capital account at beginning of quarter	(b) Capital contributed during quarter	(c) Taxable income (net loss) from line 1b below	(d) Nontaxable income	(e) Unallowable deductions	(f) Withdrawals and distributions	(g) Capital account at end of quarter (combine cols. (a) through (f))
				( )	( )	

Caution: *Refer to Instructions for Residual Holder on back of Copy B before entering information from this schedule on your tax return.*

1a Taxable income (net loss) of the REMIC for the calendar quarter . . . .

b Your share of the taxable income (net loss) for the calendar quarter . . . .

2a Sum of the daily accruals under section 860E for all residual interests for the calendar quarter . . . .

b Sum of the daily accruals under section 860E with respect to your interest for the calendar quarter . . . . . .

c Excess inclusion for the calendar quarter with respect to your residual interest (subtract line 2b from line 1b, but do not enter less than zero) . . . .

3 **Residual holders who are individuals or other pass-through interest holders. (See instructions.) (Not required to be completed for other entities):**

a Section 212 expenses of the REMIC for the calendar quarter . . . .

b Your share of section 212 expenses for the calendar quarter. (If you are an individual, this amount must be included in gross income in addition to the amount shown on line 1b. See instructions for treatment of this amount as a miscellaneous itemized deduction if you are an individual.) . . . .

For Paperwork Reduction Act Notice, see Form 1066 instructions. **Schedule Q (Form 1066)** (Rev. 1-90)

Tax Shelters

Investments that yield tax benefits are sometimes called "tax shelters." In some cases, Congress has concluded that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of investments. In many cases, however, losses from tax shelters produce little or no benefit to society or the tax benefits are exaggerated beyond those intended. Those cases are referred to as "abusive tax shelters." An investment that is considered a tax shelter is subject to restrictions, including the requirement that it be registered, as discussed later, unless it is a projected income investment.

Passive activity losses and credits. Congress determined that extensive tax shelter activity contributed to public concerns about the fairness of the tax system. In response to these concerns, Congress enacted the passive activity loss and credit rules. These rules limit the amount of losses and credits that can be claimed from such activities and limit the amount that can offset nonpassive income, such as certain portfolio income from investments. For more detailed information about determining and reporting income, losses, and credits from passive activities, see Publication 925, *Passive Activity and At-Risk Rules.*

Projected income investment. Special rules apply to a tax shelter that is not expected to reduce the tax liability of any investor. That tax shelter is considered to be a projected income investment. To qualify as a projected income investment, the tax shelter must not be expected to reduce the ***cumulative tax liability*** of any investor during any year of the first 5 years ending after the date the investment was offered for sale. In addition, the assets of a projected income investment must not include or relate to more than an incidental interest in:

1) Master sound recordings,
2) Motion picture or television films,
3) Videotapes,
4) Lithograph plates,
5) Copyrights,
6) Literary, musical, or artistic compositions, or
7) Collectibles (such as works of art, rugs, antiques, metals, gems, stamps, coins, or alcoholic beverages).

Tax shelters that qualify as projected income investments are not subject to the registration rules for tax shelters, described later. However, the requirement to maintain a list of investors that is in effect for tax shelters also applies to any projected income investment, except for one an investor later transfers. See *Transfer of interests in a tax shelter,* later.

A tax shelter that previously qualified as a projected income investment may later be disqualified if, in one of its first 5 years, it reduces the cumulative tax liability of any investor. In that case, the tax shelter becomes subject to the registration rules for tax shelters, described later.

Abusive Tax Shelters

Abusive tax shelters are marketing schemes that involve artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.

Abusive tax shelters commonly involve package deals that are designed from the start to generate losses, deductions, or credits far in excess of present or future investment, or that promise investors from the start that future inflated appraisals will enable them, for example, to reap charitable contribution deductions based on those appraisals. (But see the appraisal requirements discussed under *Curbing Abusive Tax Shelters.*) They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or "write-off") is frequently said to be several times greater than one-to-one.

Since there are many abusive tax shelters and more are developed daily by promoters, it is not possible to list all the factors you should consider in determining whether an offering is an abusive tax shelter. However, you should ask the following questions, which might provide a clue to the abusive nature of the plan.

Do the tax benefits far outweigh the economic benefits?

Is this a transaction you would seriously consider, apart from the tax benefits, if you hoped to make a profit?

Do shelter assets really exist and, if so, are they insured for less than their purchase price?

Is there a nontax justification for the way profits and losses are allocated to partners?

Do the facts and supporting documents make economic sense? In that connection, are there sales and resales of the tax shelter property at ever increasing prices?

Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?

Does the promoter offer to backdate documents after the close of the year and are you instructed to backdate checks covering your investment?

Is your debt a real debt or are you assured by the promoter that you will never have to pay it?

Does this transaction involve laundering United States-source income through foreign corporations incorporated in a tax haven and owned by United States shareholders?

Curbing Abusive Tax Shelters

Congress has enacted a series of income tax laws designed to halt the growth of abusive tax shelters. In addition to the rules on passive activity losses and credits, some of the other provisions include the following:

1) ***Registration of tax shelters.*** Generally, the organizers of certain tax shelters must register the shelter with the IRS. The IRS will then assign the tax shelter a registration number. If you are an investor in a tax shelter, the seller (or the transferor) must provide you with the tax shelter registration number at the time of sale (or transfer) or within 20 days after the seller or transferor receives the number if that date is later. See *Investor Reporting,* later, for more information about reporting this number when filing your tax return.

2) ***List of investors.*** Organizers and sellers of any potentially abusive tax shelter must maintain a list identifying each investor. (This rule, however, does not apply to an investor who, as a seller, later transfers an interest in a tax shelter that is a projected income investment.) The list must be available for inspection by the IRS and the information required to be included on the list generally must be retained for 7 years. See *Transfer of interests in a tax shelter,* later, for additional information.

3) ***Appraisals of donated property.*** Generally, if the value of property you donate exceeds $5,000 ($10,000 in case of privately traded stock), you must get a written "qualified" appraisal of the property's fair market value and attach an appraisal summary to your income tax return. The appraisal must be done by a "qualified" appraiser who is not the taxpayer, a party to a transaction in which the taxpayer acquired the property, the donee, or an employee or related party of any of the preceding persons. (Related parties are defined later under *Related Party Transactions.*) For more information about appraisals, see Publication 561, *Determining the Value of Donated Property.*

4) ***Interest on penalties.*** If you are assessed an accuracy-related or fraud penalty (as discussed under *Penalties,* later), interest will be imposed on the amount of the penalty from the due date of the return (including any extensions) to the date of payment of the penalty.

5) ***Accounting methods and capitalization rules.*** Tax shelters generally may not use the cash method of accounting. Also, uniform capitalization rules generally apply to the production or purchase of inventory goods, to constructed business property, and to noninventory property produced or purchased for sale. Under the uniform capitalization rules, the direct cost and a portion of the indirect cost attributable to the property must be capitalized or included in inventory. For more information, see Publication 538, *Accounting Periods and Methods.*

Investor Reporting

If you include on your tax return any deduction, loss, credit or other tax benefit, or any income, from an interest in a tax shelter required to be registered, you must report the registration number the tax shelter provided to you. (See *Registration of tax shelters,* earlier.) Complete and attach **Form 8271,** *Investor Reporting of Tax Shelter Registration Number,* to your return to report the number and to provide other information about the tax shelter and its benefits. You must also attach Form 8271 to any application for tentative refund (Form 1045) and to any amended return (Form 1040X) on which such benefits are claimed or income is reported. If you do not include the registration number with your return, you will be subject to a penalty of $250 for each such failure, unless the failure is due to reasonable cause.

Exception. Even if you have an interest in a registration-required tax shelter, you do not have to file Form 8271 if you did not claim any deduction, loss, credit, or other tax benefit, or report any income from that tax shelter.

Transfer of interests in a tax shelter. If you hold an investment interest in a tax shelter and later transfer that interest to another person, you must either maintain a list identifying each person to whom you transferred your interest or require a designated person or seller to maintain the list. However, see *Special rule for investors,* later, for an exception to this requirement. If you choose to delegate this requirement, you must submit to the designated person or seller all of the information that you would otherwise be required to maintain on the list.

If the tax shelter is not a projected income investment, described earlier, you must provide its registration number as well as a notification to each person to whom you transferred your interest in that tax shelter. This notification must be substantially in the following form:

> You have acquired an interest in [name and address of tax shelter]. If you transfer your interest in this tax shelter to another person, you are required by the Internal Revenue Service to keep a list containing that person's name, address, taxpayer identification number, the date on which you transferred the interest, and the name, address, and tax shelter registration number of this tax shelter. If you do not want to keep such a list, you must (1) send the information specified above to [name and address of designated person], who will keep the list for this tax shelter, and (2) give a copy of this notice to the person to whom you transfer your interest.

If you do not maintain the required list of investors, or do not delegate a designated person or seller to maintain the list, you will be subject to a penalty of $50 for each person required to be on the list, unless you can show that the failure to comply with this requirement was due to reasonable cause and not willful neglect. The maximum penalty under this provision is limited to $100,000 for each tax shelter in each calendar year.

Special rule for investors. If you are an investor who later transfers an interest in a projected income investment, described earlier, you are not required to maintain a list of investors unless the tax shelter was no longer a projected income investment before the transfer.

Penalties

Investing in an abusive tax shelter may be an expensive proposition when you consider all of the consequences. First, the promoter generally charges a substantial fee. If your return is examined by the IRS and a tax deficiency is determined, you will be faced with payment of additional tax, interest on the underpayment, possibly a 20% accuracy-related penalty, or a 75% civil fraud penalty. Also, the penalty for failure to make the proper estimated tax payments may apply. You may also be subject to the penalty for failure to pay tax. These penalties are explained in the following paragraphs.

Accuracy-related penalties. A 20% accuracy-related penalty can be imposed for underpayments of tax due to negligence or disregard of rules or regulations, substantial understatement of tax, or substantial valuation overstatement. This penalty will not be imposed if you can show that you had reasonable cause for any understatement of tax and that you acted in good faith.

If you are charged an accuracy-related penalty, interest will be imposed on the amount of the penalty from the due date of the return (including extensions) to the date of payment of the penalty.

Negligence. The penalty for negligence or disregard of rules or regulations is imposed only on the portion of the underpayment that is attributable to negligence or disregard of rules or regulations. The penalty will not be charged if you can show that you had reasonable cause for understating your tax and that you acted in good faith.

Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code.

To prove you acted with reasonable cause and in good faith, you should make a complete disclosure of each item in question. Such disclosure must be full and substantive and be clearly identified as having been made to avoid imposition of the accuracy-related penalty.

Use **Form 8275,** *Disclosure Statement*, to make your disclosure, and attach it to your tax return. A Form 8275 is shown on the next page.

Instead of using Form 8275, you can make your disclosure by following the procedures given in Notice 90-20.

Substantial understatement of tax. An understatement is considered to be substantial if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The term "understatement" is the amount of tax required to be shown on your return for a tax year less the amount of tax shown on the return, reduced by any rebates.

The understatement is considered to be due to a tax shelter if it is the result of a partnership or other entity (such as a corporation or trust), an investment plan, or other arrangement, whose principal purpose, based on objective evidence, is the avoidance or evasion of federal income tax. An understatement of tax does not include any tax due to a tax shelter item (such as an item of income, gain, loss, deduction, or credit) if you had substantial authority for the tax treatment of the item and reasonably believed that the tax treatment chosen was more likely than not the proper one. Keep in mind, however, that a disclosure (the attachment of a detailed explanation of tax treatment or Form 8275) of the tax shelter item on a tax return does not reduce the amount of the understatement. For other than tax shelters, Form 8275 is filed to disclose items that could cause a substantial understatement of income tax in order to avoid the substantial understatement penalty.

This understatement penalty will not be imposed if you can show that there was reasonable cause for the underpayment attributable to the understatement and that you acted in good faith. An important factor in establishing reasonable cause and good faith will be the extent of your effort to determine your proper tax liability under the law.

The IRS will waive the substantial understatement penalty if you file a "qualified amended return." A ***qualified amended return*** is an amended return showing an additional amount of tax or adequate disclosure filed before:

- The IRS contacts you about an examination of your return, or
- The IRS contacts your tax shelter promoter or related pass-through entity (partnership, S corporation, etc.) about the tax shelter item.

Overvaluation of property. You may be liable for a penalty if you overstate the value or adjusted basis of property. In general, you are liable for the penalty if:

The value or adjusted basis of any property claimed on the return is 200% or more of the correct amount,

You underpaid your tax by at least $5,000 because of the overstatement, and

You cannot establish that you had reasonable cause for the underpayment or that you acted in good faith.

You may be assessed a penalty of 40% for a ***gross valuation misstatement.*** If you overstate the value or the adjusted basis of property by 400% of the amount determined to be correct, you will be assessed a penalty of 40%, instead of 20%, of the amount of tax you underpaid because of the gross overvaluation.

Civil fraud penalty. If there is any underpayment of tax on your return due to fraud, a penalty of 75% of this underpayment will be added to your tax.

Joint return. The fraud penalty on a joint return applies to each spouse only to the extent that the underpayment is due to the fraud of that spouse.

Failure to pay tax. If a deficiency is assessed and is not paid within 10 days of the demand for it, an investor may be penalized with up to a 25% addition to tax if such failure to pay continues.

Abusive Tax Shelter Detection Program

The IRS has implemented a program to detect and identify those returns, claims, or applications for refund, in which benefits from abusive tax shelter promotions are claimed. Under this program, the IRS will detect and identify such returns, claims, and applications before processing and before refunds are paid. When appropriate, the IRS will reduce refunds that are specifically attributable to the abusive tax shelter.

Returns subject to review under this program include those in which pre-filing notification letters, described later, have been sent to investors and those returns that are selected on the basis of certain criteria that identify particularly abusive tax shelter promotions.

Loss carryback adjustments. Under the detection program, the IRS also may offset an assessed deficiency against a scheduled refund resulting from a decrease in tax based on the carryback of a net operating loss. (**Form 1045,** *Application for Tentative Refund*, is used to apply for a quick refund of taxes from such carrybacks.) This action may occur when a determination is made that it is highly likely that there is:

1) A gross valuation overstatement, or
2) A false or fraudulent statement, with respect to the tax benefits to be secured by holding an interest in the tax shelter entity or arrangement, that would be subject to the penalty under Section 6700 of the Internal Revenue Code (relating to the promotion of abusive tax shelters).

This treatment also applies to returns, claims, or applications relating to a partnership interest in a tax shelter promotion.

Pre-filing notification letter. If you are an investor in an abusive tax shelter promotion, the IRS may send you a "pre-filing notification letter" if it determines that it is highly likely that there is:

1) A gross valuation overstatement, or
2) A false or fraudulent statement regarding the tax benefits to be derived from the tax shelter entity or arrangement.

This letter will advise you that, based upon a review of the promotion, it is believed that the purported tax benefits are not allowable. The letter also will advise you of the possible tax consequences if you claim the benefits on your income tax return.

You also may receive a notification letter after you file your tax return. If you have already claimed the benefits on your tax return, you will be advised that you may file an amended return. However, any applicable penalties still may be asserted.

If you claim the benefits after receiving the pre-filing notification or if you fail to amend your return, you will be notified that your tax return is being examined. Normal audit and appeal procedures will be followed during the examination, and accuracy-related, civil or criminal fraud, and other penalties will be considered and, when appropriate, asserted. For information on the examination of returns, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.*

Revenue rulings. The IRS has published numerous revenue rulings concluding that the claimed tax benefits of various abusive tax shelters should be disallowed. A revenue ruling is the conclusion of the IRS on how the law is applied to a particular set of facts. Revenue rulings are published in the *Internal Revenue Bulletin* for taxpayers' guidance and information and also for use by IRS officials. So, if your return is examined and an abusive tax shelter is identified and challenged, a published revenue ruling dealing with that type of shelter, which disallows certain claimed tax shelter benefits, would serve as the basis for the examining official's challenge of the tax benefits that you claimed. In such a case, the examiner will not compromise even if you or your representative believe that you have authority for the positions taken on your tax return.

The courts have generally been unsympathetic to taxpayers involved in abusive tax shelter schemes and have ruled in favor of the IRS in the majority of the cases in which these shelters have been challenged.

New financial products. The IRS Office of Chief Counsel has an organization devoted to identifying and analyzing new financial products that are being created and sold to investors in public offerings. This organization provides guidance about the tax consequences of transactions through the issuance of revenue rulings and regulations.

The IRS encourages taxpayers and tax practitioners to submit prospectuses and/or other written descriptions of current investment transactions to the Office of Chief Counsel at the following address:

Assistant Chief Counsel
(Financial Institutions and Products)
Room 4300
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Whether to Invest

In light of the adverse tax consequences and the substantial amount of penalties and interest that will result if the claimed tax benefits are disallowed, you should consider tax shelter investments carefully, and seek competent legal and financial advice.

Form **8275**
(Rev. May 1990)
Department of the Treasury
Internal Revenue Service

Disclosure Statement

► Attach to your tax return. ► See separate instructions.

OMB No. 1545-0889
Expires 4-30-93

Name(s) shown on return

Identifying number shown on return

Part I **General Information**

(a) Detailed description of item (or group of similar items) being disclosed and the location of the item(s) on your return, including schedule and line (e.g. Schedule A, line 21).	(b) Amount of disclosed item described in column (a)
1	
2	
3	
4	

Part II **Detailed Explanation**

1 ....

2 ....

3 ....

4 ....

Part III **Information About Pass-Through Entity** (To be completed by partners, shareholders, beneficiaries, or residual interest holders.)

Note: *A pass-through entity is a partnership, an S corporation (as defined in section 1361(a)(1)), an estate, a trust, a regulated investment company (as defined in section 851(a)), a real estate investment trust (as defined in section 856(a)), or a real estate mortgage investment conduit* ***(REMIC).***

(Complete this part only if you are making adequate disclosure with respect to a pass-through item.)

1 Name, address, and ZIP code of pass-through entity

2 Identifying number of pass-through entity

3 Tax year of pass-through entity
/ / to / /

4 Internal Revenue Service Center where the pass-through entity filed its return

For Paperwork Reduction Act Notice, see separate instructions.

Form **8275** (Rev. 5-90)

Investment Expenses

Words you may need to know (see Glossary):

At-risk rules
Passive activity
Portfolio income

This part explains what investment expenses you may deduct if you itemize your deductions on Schedule A of Form 1040. It includes information on interest expenses, the limit on investment interest, expenses of producing income, and nondeductible expenses.

At-risk rules. Special at-risk rules apply to most income-producing activities. These rules limit the amount of loss you can deduct to the amount you risk losing in the activity. Generally, this is the amount of cash and the adjusted basis of property you contribute to the activity. It also includes money you borrow for use in the activity if you are personally liable for repayment or if you use property not used in the activity as security for the loan. For more information, see Publication 925, *Passive Activity and At-Risk Rules.*

Passive activity losses and credits. The amount of losses and tax credits you can claim from passive activities is limited. Generally, you are allowed passive activity losses only up to the amount of your passive activity income. Also, you can use credits from passive activities only against tax on the income from passive activities. There are exceptions for certain activities, such as rental real estate activities. Also, phase-in rules apply to some losses.

A passive activity generally is any activity involving the conduct of any trade or business in which you do not materially participate, and rental activities. For this purpose, the term ***trade or business*** includes any activity that involves the conduct of a trade or business and, to the extent provided in regulations, any activity in connection with a trade or business and any activity engaged in for the production of income. You are considered to materially participate in an activity if you are involved on a regular, continuous, and substantial basis in the operations of the activity.

Other income (nonpassive income). Generally, only income from passive activities can be used to offset losses from passive activities. Consequently, you generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. ***Portfolio income*** is gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It also includes gains or losses (not derived in the ordinary course of a trade or business) from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment. Portfolio income does not include Alaska Permanent Fund dividends.

Expenses (other than interest) which are clearly and directly allocable to your portfolio income and interest expense properly allocable to such income do not enter into the computation of your passive activity income or loss. However, such interest and other expenses may be subject to other limits. These limits will be explained in the remainder of this section.

For more information about determining and reporting income and losses from passive activities, see Publication 925.

Interest Expenses

As an investor, you may deduct certain interest expenses. These expenses are discussed in this part. Other interest expense deductions, including home mortgage interest, are discussed in Publication 545, *Interest Expense.*

Investment interest. If you borrow money that is allocable to property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you may not deduct interest you incurred to produce tax-exempt income. See *Tax-exempt income* under *Nondeductible Expenses,* later.

Investment interest does not include any qualified residence interest or any interest taken into account in computing income or loss from a passive activity.

Allocation of interest expense. Your deduction for interest expense may be limited, depending on how the debt proceeds are used. If the money you borrowed is used for business or personal purposes as well as for investment, you must allocate the debt among those purposes. You allocate the interest expense on that debt according to how you used the debt proceeds. However, fully deductible home mortgage interest is not allocated, regardless of how the proceeds are used.

If you use borrowed funds to purchase an interest in, or make a contribution to, a partnership or S corporation, then the interest on those funds has to be allocated based on the assets of the entity. For more information, see Publication 545.

Example. You borrow $10,000 and use $8,000 to purchase stock. The other $2,000 is used to purchase items for your home. Since 80% of the debt is used for, and allocated to, investment purposes, 80% of the interest on that debt is investment interest. The other 20% is personal interest. (This is basically how the allocation rule works; however, see the next example in this discussion for other calculations you may have to make.)

Interest you pay on debt proceeds that you received in cash is generally treated as personal interest. If you deposit debt proceeds in an account, that deposit is treated as an investment expenditure and amounts held in the account are treated as investment property, regardless of whether the account bears interest. Any interest you pay on the deposited proceeds is investment interest.

You can treat any expenditure made from any account (or in cash) within 30 days before or after the debt proceeds are deposited (or received) as made from such proceeds.

Interest expense generally is subject to the limitations that apply to the expenditure to which the underlying debt is allocated. For example, if your debt proceeds are allocated to an investment expenditure, any otherwise allowable deduction for the interest expense on that debt is subject to the limits that apply to the deduction for investment interest. Similarly, if your debt proceeds are allocated to an expenditure in connection with a passive activity, any otherwise allowable interest expense deduction is subject to the passive loss limitation. The allocation of the debt proceeds also depends on when you use the proceeds. In addition, you must reallocate the proceeds as you repay the debt.

Example. Assume in the previous example that you borrowed the money on March 1 and immediately purchased the stock for $8,000. You did not purchase the household items until June 1. You had deposited the $2,000 in the bank. The $2,000 is treated as being used for an investment purpose for the 3-month period. Therefore, your total interest expense for 3 months on this debt is investment interest. In June you must begin to allocate 80% of the debt and the interest expense for investment and 20% for personal purposes.

As you repay the debt, you must first reduce the amount allocated for personal purposes. You then reallocate what portion is for investment purposes.

If, in this example, you repay $500 on November 1, the entire repayment is applied against the amount allocated for personal purposes. The debt is now allocated as $8,000 for investment purposes, and $1,500 for personal purposes. Therefore, until the next reallocation is necessary, 84% ($8,000 ÷ $9,500) of the debt and the interest expense is allocated for investment.

For more information about allocating interest expense, see Publication 545. The limits on your deduction for investment interest are discussed later in this section. Publication 925 contains information about the passive activity loss limitation phase-in rules that may affect your interest expense computation.

When deductible. If you use the cash method of accounting, you must pay the interest before you can deduct it.

If you use the accrual method of accounting, you can deduct interest over the period it accrues, regardless of when you pay it.

Example. You borrowed $1,000 on September 8, 1990, payable in 90 days at 12% interest. On December 4, 1990, you paid this with a new note for $1,030, due on March 2, 1991. If you use the cash method of accounting, you may not deduct any portion of the $30 interest on your return for 1990 because you did not actually pay it. If you use the accrual method, you may be able to deduct a portion of the interest on the loans through December 31, 1990, on your return for 1990.

Interest paid in advance. Generally, if you pay interest in advance for a period that goes beyond the end of the tax year, you must spread the interest over the tax years to which it belongs. You may deduct in each year only the interest for that year.

Interest on margin accounts. If you are a cash basis taxpayer, you can deduct interest on margin accounts as investment interest in the year you paid it. You are considered to have paid interest on these accounts only when you actually pay the broker or when the interest becomes available to the broker through your account. Receipts for the payment of interest may become available in your account when the broker collects dividends or interest for your account, or sells securities held for you or received from you. But also see *Interest expense and carrying charges relating to straddles* under *Straddles Involving Interests in Personal Property,* later.

Deferral of interest expense deduction for interest on a market discount bond. The amount you can deduct for interest expense you incurred to purchase or carry a market discount bond is limited. To find your deduction, first figure the excess, if any, of the amount of interest expense incurred for the year to purchase or carry the bond over the total interest and OID includible in gross income for the bond for the year. This excess is then reduced by the market discount allocable to the number of days you held the bond during the year. The result is your interest expense deduction for the year. (Figure the allocable market discount using the rules discussed under *Accrued market discount,* earlier in *Market Discount Bonds.*)

Disallowed interest expense. In the year you dispose of the bond, you can deduct the amount of any interest expense you were not allowed to deduct for an earlier year.

Choosing to deduct disallowed interest expense in a year prior to the year of disposition. You may choose to deduct disallowed interest expense in a year prior to the year you dispose of a bond if there is net interest income from the bond during the year. This choice allows you to deduct any disallowed interest expense attributable to the bond to the extent the disallowed interest expense does not exceed the net interest income from that bond. The balance of the disallowed interest expense remains deductible in the year you dispose of the bond.

Net interest income is the interest income (including OID) from the bond that you include in income for the year minus the interest expense incurred during the year to purchase or carry the bond.

Deferral of interest deduction on short-term obligations. If the current income inclusion rules discussed earlier under *Discount on Short-Term Obligations* do not apply to you, there is a limit on the interest expense you can deduct for interest expenses you incurred to purchase or carry a short-term obligation.

Interest is deductible only to the extent your net direct interest expense for the tax year exceeds the amount of acquisition discount or OID included in income for the tax year and the amount of any interest payable on such obligations (other than interest taken into account in determining the amount of acquisition discount or OID). Interest payable, in this case, is any amount that accrued while you held the obligations but that was not included in your income by reason of your accounting method. The method of determining acquisition discount and OID for short-term obligations is discussed earlier under *Discount on Short-Term Obligations.*

Net direct interest expense is the excess of the amount of interest incurred during the year to purchase or carry the obligation over the total amount of interest (including OID) from the obligation that is includible in your income for the year.

Disallowed interest expense. In the year you dispose of the obligation, or if you choose, in another year in which you have net interest income from the bond, you can deduct the amount of any interest expense you were not allowed to deduct for an earlier year. Follow the same rules provided in the earlier discussion under *Deferral of interest expense deduction for interest on a market discount bond.*

Limit on Investment Interest

The amount of investment interest you can deduct in 1990 may be limited. This limit applies to paid or accrued interest on money that you borrowed that is properly allocable to investment property, or disallowed investment interest carried over from 1989.

Form 4952. Use Form 4952, *Investment Interest Expense Deduction,* to figure your total deduction for investment interest. However, if your only investment income was from interest or dividends, you do not have any other deductible expenses directly connected with the production of that income, and your investment interest does not exceed the total of that income, you do not have to complete Form 4952. See *How to Report Investment Expenses,* later, for more information.

Investment interest generally is the interest you paid or accrued on money you borrowed that is properly allocable to property held for investment.

Investment property. Property held for investment includes property that produces **portfolio income,** such as interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Portfolio income also includes net gain (not derived in the ordinary course of a trade or business) from the sale or trade of property producing this type of income or held for investment (other than an interest in a passive activity).

Limit on investment interest. The excess interest amount previously allowed is being phased out. Generally, for 1990, you may claim a deduction for investment interest expense of up to the amount of your ***net investment income*** plus 10% of any excess investment interest over your net investment income, but not more than $1,000 ($500 if married and filing a separate return). After 1990, no deduction will be allowed for any excess investment interest.

You may ***carry forward*** the amount of investment interest that you could not deduct because of this limit to the next tax year. The interest carried forward is treated as investment interest paid or accrued in that later year.

Partners, shareholders, and beneficiaries. To determine whether you exceed the limit on investment interest, combine your share of investment interest from a partnership, S corporation, estate or trust with your other investment interest.

Net investment income. For purposes of figuring the limit on the deduction for investment interest, determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income. See also *Losses from passive activities,* later in this discussion.

Investment income generally includes gross income you derived from property held for investment (such as interest, dividends, annuities, and royalties), and any net gain you derived from disposing of investment property. Investment income does not include Alaska Permanent Fund dividends.

Investment expenses, for purposes of determining net investment income, include all income-producing expenses (other than interest expense) relating to the investment property that are allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions. In figuring the amount over the 2% limit, expenses that are not investment expenses are disallowed before any investment expenses are disallowed. See *Expenses of Producing Income,* later, for a discussion of the 2% limit.

Example. Jane Smith, a single taxpayer, has investment income in 1990 from dividends and a net gain on the sale of investment property, which together total $12,000. Jane's 1990 investment expenses (other than interest), which were directly connected with the production of this income, amounted to $980 after taking into account the 2% limit on miscellaneous itemized deductions. Jane also incurred $12,500 of investment interest expense in 1990.

Jane figures her net investment income and the limits on the amount of her investment interest expense deduction for 1990 in the following way:

Total investment income	$12,000
Minus: Investment expenses (other than interest)	980
Net investment income	$11,020
Minus: Investment interest expense	12,500
Excess interest expense subject to limit in 1990	$ 1,480

For 1990, Jane's investment interest expense deduction is limited to $11,020, the amount of her net investment income, plus $148, or 10% of the excess interest expense ($1,480), for a total deduction of $11,168.

Form 4952 for Jane Smith is illustrated on Page 28.

Losses from passive activities. Income or expenses that you used in computing income or loss from a passive activity are not included in determining your investment income or investment expenses (including investment interest expense). However, in determining net investment income for tax years 1987 through 1990, your investment income must be reduced by the amount of the passive activity loss that you are allowed as a deduction under the passive loss limitation phase-in rules. Investment income is not reduced, however, by any portion of the passive activity loss from any rental real estate activity in which you actively participate. See Publication 925 for more information.

Example 1. Ted is a partner in a partnership that operates a business. However, he does not materially participate in the partnership's business. In 1990, Ted's interest in the partnership is considered a passive activity.

For 1990, Ted's investment income from interest and dividends is $10,000 and the investment expenses (other than interest) are $3,200 after taking into account the 2% limit on miscellaneous itemized deductions. His investment interest expense is $8,000. Ted also has income from the partnership of $2,000.

Ted figures his net investment income and the limits on the amount of his investment interest expense deduction for 1990 in the following way:

Total investment income	$10,000
Minus: Investment expenses (other than interest)	3,200
Net investment income	$ 6,800
Minus: Investment interest expense	8,000
Excess interest expense subject to limit in 1990	$ 1,200

The $2,000 of income from the passive activity is not used in determining Ted's net investment income. His investment interest deduction is limited to $6,800, the amount of his net investment income, plus $120, or 10% of the excess interest expense ($1,200), for a total deduction of $6,920.

Note. Ted's net investment income and the amount of his investment interest deduction would remain the same even if Ted had incurred a partnership loss that was not eligible for treatment under the phase-in rules for certain passive activity losses. The treatment of a partnership loss that was eligible for treatment under the phase-in rules is illustrated in Example 2.

Example 2. Assume the same facts as in Example 1, except that Ted acquired the partnership interest in 1985 and incurred a $2,000 loss from the partnership business in 1990. Since Ted's interest in the partnership is eligible for application of the phase-in rules (that allow him to claim a part of this passive activity loss as an offset to non-passive income), Ted must reduce his investment income by the amount of loss allowed under those rules. For 1990, Ted is allowed to deduct 10% of the passive activity loss of $2,000, or $200.

Therefore, Ted's net investment income for purposes of determining the limit on his investment interest expense is $6,600 ($10,000 − $200 − $3,200). His investment interest deduction is limited to $6,600, the amount of the net investment income, plus $140, or 10% of the excess interest expense of $1,400 ($8,000 − $6,600), for a total deduction of $6,740.

Bond Premium Amortization

If you buy a bond that yields taxable interest, you can choose to amortize the premium you pay to buy the bond. To amortize a premium means to deduct a part of the premium each year over the life of the bond. If you make this choice, you must reduce your basis in the taxable bond by a part of the premium each year over the life of the bond. If you do not choose to amortize the bond premium, it will be treated as part of your basis of the bond. The discussion on making this choice appears later under *Choosing to Amortize.*

If you buy a bond that yields tax-exempt interest, you must amortize any premium you paid to buy the bond. This amortized amount is not deductible in determining taxable income.

Bond premium is the amount by which a bond sells above its face, or maturity, value. For example, a bond with a face value of $1,000 would have a $50 premium if it sells for $1,050.

A taxable bond that is subject to a call before it matures may be redeemed by the issuer before the scheduled maturity date. The bond premium is determined by reference to the amount the issuer will pay at the earlier call date if the call results in a smaller amortizable bond premium for the period ending on the call date.

Basis. You decrease the basis of the bond by the amortizable bond premium in all cases in which you are required, or choose, to amortize the premium. Use the resulting adjusted basis to figure your gain or loss on the sale or redemption of the bond. Gains and losses are discussed later under *How to Figure Gain or Loss.*

If the interest on the bond is exempt from tax, you cannot deduct the amortization even though you must reduce the basis of the bond each year by a part of the premium.

Bonds acquired in an exchange after May 6, 1986. If you receive a bond after May 6, 1986, in exchange for other property and the basis of the bond is determined (in whole or in part) by reference to the basis of the other property, then in determining the amortizable bond premium, your basis for the bond cannot exceed the bond's fair market value immediately after the exchange. This treatment does not apply to an exchange of a bond for another bond if the exchange is part of a corporate reorganization.

A dealer in taxable bonds (or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business and who would properly include bonds on hand in inventory at the close of the tax year) cannot claim a deduction for amortizable bond premium. Instead, the premium is part of the cost of the bonds.

See section 75 of the Internal Revenue Code for purposes of determining your gross income if you are a dealer in tax-exempt bonds.

Premium on a convertible bond. If you paid a premium for a convertible bond, you may not amortize or deduct the amount of the premium attributable to the conversion feature of the bond.

Yield method. You generally amortize bond premium using the constant yield method. This method is explained in Revenue Ruling 82-10.

Bonds purchased before October 23, 1986. On a taxable bond you purchased before October 23, 1986, the amortizable bond premium is a miscellaneous itemized deduction not subject to the 2% limit.

Bonds acquired after October 22, 1986, and before 1988. On a taxable bond you acquired after October 22, 1986, and before 1988, the amortizable bond premium is treated as an interest expense and is subject to the investment interest limit (discussed earlier under *Interest Expenses*). However, you can elect to treat amortizable bond premium as an offset to interest income on the bond, as discussed later under *How to Report Bond Premium Amortization.*

Bonds acquired after 1987. On a taxable bond you acquired after 1987, the amortizable bond premium is an offset to interest income on the bond, rather than a separate interest deduction. Therefore, you reduce your interest income and the basis of the bond by the amount of the amortized premium.

Choosing to Amortize

You choose to amortize the premium on taxable bonds by deducting, or offsetting, the amortized premium on your income tax return for the first tax year for which you want the choice to apply. You must attach a statement to your return showing how you figured your deduction. See *How to Report Bond Premium Amortization* later.

This choice is binding for the year you make it and for later tax years. It applies to all similar bonds you own in the year you make the election and also to those you acquire in later years.

You may change your decision to amortize bond premium only with the written approval of the IRS.

How to Report Bond Premium Amortization

How you deduct your bond premium amortization depends on when you acquired the bond. However, you must file Form 1040 if you amortize bond premiums.

Taxable bonds acquired before October 23, 1986. For these bonds, deduct amortizable bond premium on line 26 of Schedule A (Form 1040) as a miscellaneous itemized deduction not subject to the 2% of adjusted gross income limit.

Taxable bonds acquired after October 22, 1986, but before 1988. For these bonds, claim the amortizable bond premium on line 11 of Schedule A (Form 1040). Use **Form 4952,** *Investment Interest Expense Deduction,* to figure your allowable deduction and attach the form to your return.

If you choose to offset the premium against the bond's interest income, see *Taxable Bonds acquired after 1987,* next.

Taxable bonds acquired after 1987. For all taxable bonds acquired after 1987, the amortizable bond premium is offset against the interest income from the bond. This offset also applies to taxable bonds acquired after October 22, 1986, and before 1988, for which you elect to offset the premium against interest income.

Offset your interest income from a bond by reporting the bond's interest on line 1 of Schedule B (Form 1040). Several lines above line 2, put a subtotal of all interest listed on line 1. Below this subtotal, write "ABP Adjustment,"and the amount. Subtract this amount from the subtotal, and enter the result on line 2.

Expenses of Producing Income

You can deduct certain ordinary and necessary expenses as ***miscellaneous deductions*** only if you are otherwise able to itemize deductions on Schedule A (Form 1040). To be deductible, these expenses must be paid or incurred:

1) To produce or collect income,
2) To manage property held for producing income, or
3) In connection with the determination, collection, or refund of any tax.

The expenses must be directly related to the income or income-producing property, and the income must be taxable to you.

The deduction for most income-producing expenses is subject to a ***2% limit*** that also applies to certain other miscellaneous itemized deductions. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of your adjusted gross income.

The 2% limit also applies to those investment expenses that are allocated to shareholders and partners by certain ***pass-through entities,*** such as S corporations, partnerships, regulated investment companies or mutual funds, and REMICs. However, allocated investment expenses of publicly-offered mutual funds are not subject to the 2% limit.

For more information on how to report expenses of producing income, see *How to Report Investment Expenses,* later.

Attorney or accounting fees. You can deduct attorney or accounting fees that are necessary to produce or collect taxable income. However, in some cases attorney or accounting fees are part of the basis of property. See *Increases to basis* under *Adjusted Basis,* later.

Automatic investment service and dividend reinvestment plans. A bank may offer its checking account customers an automatic investment service for a charge, whereby each customer can choose to invest a part of the checking account each month in the common stock of certain specified corporations. Or, a bank that acts as a dividend disbursing agent for a number of publicly owned corporations may set up a plan known as an automatic dividend reinvestment service. Under the plan, cash dividends paid by a corporation are reinvested, after the bank deducts a service charge for serving as an agent for participating shareholders, in full or fractional shares of stock of the corporation. Each customer or shareholder is periodically given a statement showing the date of purchase, the purchase price including stock brokerage costs, and the accumulated number of shares and fractions in the account.

A corporation in which you own stock also may have a dividend reinvestment plan. This plan lets you choose to use your dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash.

You can deduct the monthly service charge you pay to a bank to participate in an automatic investment service plan. You also can deduct any service charge subtracted from your cash dividends before the dividends are used to buy more shares of stock. Deduct the charge in the year you pay it.

Clerical help and office rent. You can deduct office expenses, such as rent, clerical help, etc., that you incur in connection with your investments and collecting the taxable income on them.

Cost of replacing missing securities. To replace your taxable securities that are mislaid, lost, stolen, or destroyed, you may have to post an indemnity bond. You may deduct the premium you pay to buy the indemnity bond and the related incidental expenses.

You may, however, get a refund of part of the bond premium if the missing securities are recovered within a specified time. Under certain types of insurance policies you may recover some of the expenses.

If you receive the refund in the tax year you pay the amounts, you can only deduct the difference between the expenses paid and the amount refunded. If the refund is made in a later tax year, include the refund in income in the year you received it, but only to the extent that the expenses decreased your tax in the year you deducted them.

Fees. You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect income, such as your taxable bond or mortgage interest, or your dividends on shares of stock. But you cannot deduct a fee you pay to a broker to acquire investment property, such as stocks or bonds. You must add the fee to the cost of the property. See *Increases to basis* under *Adjusted Basis,* later.

You cannot deduct any broker's fees, commissions, or option premiums you pay (or that were netted out) in connection with the sale of investment property. They are selling expenses and may only be used to figure gain or loss from the sale. See *Reporting Capital Gains and Losses on Schedule D,* later, for more information about the treatment of these sale expenses.

Investment counsel and advice. You can deduct fees you pay for counsel and advice about investments if the fees relate to investments that produce taxable income. This includes amounts you pay for investment advisory services.

Safe deposit box rent. You can deduct rent you pay for a safe deposit box if you use the box to store taxable income-producing stocks, bonds, or investment-related papers and documents. You cannot deduct the rent if you use the box to store personal items or tax-exempt securities. If you use the box to store taxable securities and tax-exempt securities or personal items, you may deduct a part of the rent. See *Tax-exempt income* under *Nondeductible Expenses*, later, to figure what part you may deduct.

Sponsored investment plan. If you are a subscriber to a sponsored investment plan, you pay creation and custody fees.

Creation fee. This fee is deducted by the custodian from your deposits. It is paid to the sponsor for its services in developing, selling, and administering the plan. It is a fee paid for the privilege of getting stock through the plan. This fee is a capital expense. You must add it to the cost of the shares you get through the investment plan. You cannot deduct it.

Custody fee. This fee is paid for services performed by the custodian for holding the shares you acquired through the plan, collecting and reinvesting cash dividends, maintaining individual records, and providing you with detailed statements of your account. It is a fixed percentage of each deposit. You can deduct this fee.

State and local transfer taxes. You cannot deduct the state and local transfer taxes you pay when you buy or sell securities. If you pay these transfer taxes when you buy securities, you must treat them as part of the cost of the acquired property. If you pay these transfer taxes when you sell securities, you must treat them as a reduction in the amount realized on the disposition.

Trustee's commissions for revocable trust. If you set up a revocable trust and have its income distributed to you, you can deduct the commission you pay the trustee for managing the trust to the extent it is to produce or collect taxable income or to manage property. However, you cannot deduct any part of the commission that is for producing or collecting tax-exempt income or for managing property that produces tax-exempt income.

If you are a cash method taxpayer and pay the commissions for several years in advance, you must deduct a part of the commission each year. You cannot deduct the entire amount in the year you pay it.

Nondeductible Expenses

Some expenses that you incur as an investor are not deductible.

Regulated investment company. You cannot deduct the interest on money you borrow to buy shares of stock of a regulated investment company that distributes only exempt-interest dividends. If the company distributes both taxable and exempt-interest dividends, you cannot deduct the part of the interest that relates to the exempt-interest dividends. You may deduct the part of the interest that relates to the taxable dividends as investment interest, if you itemize deductions.

Stockholders' meetings. You cannot deduct transportation and other expenses that you pay in order to attend stockholders' meetings of companies in which you have no interest other than owning stock. This is true even though your purpose in attending is to get information that would be useful in making further investments.

You cannot deduct expenses for attending a convention, seminar, or similar meeting for investment purposes.

Single-premium life insurance and endowment contracts. You cannot deduct interest on money you borrow to buy or carry a single-premium life insurance, endowment, or annuity contract.

This includes policies for which almost all the premiums are paid within 4 years from the date of purchase, or for which an amount is deposited with the insurer for the payment of a large number of future premiums.

Systematic borrowing on insurance. Generally, you cannot deduct interest on money you borrow to buy or carry a life insurance, endowment, or annuity contract if you plan to systematically borrow part or all of the increases in the cash value of the contract. This is not limited to the borrowing of increases in the cash value.

Tax-exempt income. You cannot deduct expenses you incurred to produce tax-exempt income. Nor can you deduct interest on money you borrow to buy tax-exempt securities.

The rules relating to interest expenses on tax-exempt securities apply to amounts you pay in connection with personal property used in a short sale or amounts paid by others for the use of any collateral in connection with the short sale. However, the first of these rules will not apply to amounts paid by you if you deposit cash as collateral for the property used in the short sale and the cash does not earn a material return during the period of the sale. Short sales are discussed later.

Expenses for both tax-exempt and taxable income. You may have expenses that are for both tax-exempt and taxable income. If you cannot specifically identify what part of the expenses is for the tax-exempt income and what part is for the taxable income, you may allocate the expenses, using reasonable proportions based on facts and circumstances. You must attach a statement to your return showing the basis of the apportionment, and stating that each deduction claimed is not attributable to tax-exempt income.

One accepted method for allocating expenses is to divide them in the same proportion that your tax-exempt income is to your total income. To do this, you first must divide your tax-exempt income by your total income. Then multiply the result by your expenses to find the part of the expenses that relates to the tax-exempt income. You may not deduct this part.

Example. You received $6,000 interest — $4,800 was tax-exempt and $1,200 was taxable. In earning this income, you had $500 of expenses. You cannot specifically identify the amount of each expense item that is for each income item, so you must divide your expenses. Therefore, 80% ($4,800 tax-exempt interest divided by $6,000 total interest) of your expenses are for the tax-exempt income. You may not deduct $400 (80% of $500) of the expenses. You can deduct the balance of the expenses, $100, because they are for the taxable interest.

To figure your income so that you can divide your expenses, include your capital gains for the year. But do not include your capital losses.

State income taxes. You can deduct state income taxes on interest income that is exempt from federal income tax. But you may not deduct state income taxes on other exempt income.

How to Report Investment Expenses

To deduct your investment expenses, you must itemize deductions on Schedule A (Form 1040). Enter your deductible investment interest expense on line 11, Schedule A. Also attach a completed Form 4952, if you used that form to figure your investment interest expense. Enter the total amount for your expenses of producing income on line 21, Schedule A, and include this amount with your other miscellaneous deductions that are subject to the 2% limit, described earlier. List the type and amount of each expense; if necessary, you may show the required information on an attached statement.

Note: Bond premium amortization on bonds you acquired before October 23, 1986, is also deductible as a miscellaneous deduction on Schedule A (Form 1040). However, this investment expense is not subject to the 2% limit. List these expenses on line 26 of Schedule A. The 2% limit also does not apply to short sale expenses, described later. Instead, treat such amounts as an interest expense and include them on line 11, Schedule A.

For information on bonds acquired after October 22, 1986, see *Bond Premium Amortization*, earlier.

Investment expenses allocated through pass-through entities. If you hold an interest in a partnership, S corporation, real estate mortgage investment conduit (REMIC), or a nonpublicly-offered regulated investment company (or mutual fund), that organization will generally report to you your share of certain investment expenses. In the case of a partnership or S corporation, these expenses will be shown on your Schedule K–1. A nonpublicly-offered regulated investment company or (mutual fund) will indicate your share of the allocated investment expenses in Box 1e of Form 1099–DIV, or on an equivalent statement. Publicly-offered mutual funds are discussed later. If you hold an interest in a REMIC, any expenses relating to your residual interest investment will be shown on line 3b of Schedule Q (Form 1066); any expenses relating to your regular interest investment will appear on a separate statement accompanying the Form 1099 (or equivalent statement). Report your share of such investment expenses on Schedule A (Form 1040), subject to the 2% limit, in the same manner as your other expenses of producing income.

Including expenses in income. The investment expenses allocated to a holder of an interest in a REMIC or a nonpublicly-offered mutual fund, as described above, are considered to be indirect deductions through that pass-through entity. You must include in your gross income an amount equal to the amount of the expenses allocated to you, whether or not you are able to claim a deduction for those expenses. If you are a shareholder in a nonpublicly-offered mutual fund, you must include on your return the full amount of gross dividends or other distributions of stock, as shown in Box 1a of Form 1099–DIV or an equivalent statement. If you are a residual interest holder in a REMIC, you must report as ordinary income on Schedule E (Form 1040) the total amounts shown on lines 1b and 3b of Schedule Q (Form 1066). If you are a REMIC regular interest holder, you must include the amount of any expense allocation you received on line 8a of Form 1040.

Publicly-offered mutual funds. Publicly-offered mutual funds, generally, are funds that are traded on an established securities exchange. This type of fund reports to you on Form 1099–DIV, in Box 1a, your net dividend income (gross dividends minus investment expenses). Include this net figure in your income.

Cash method. If you use the cash method of reporting income and expenses, you deduct your expenses, except for certain prepaid interest, in the year you pay them.

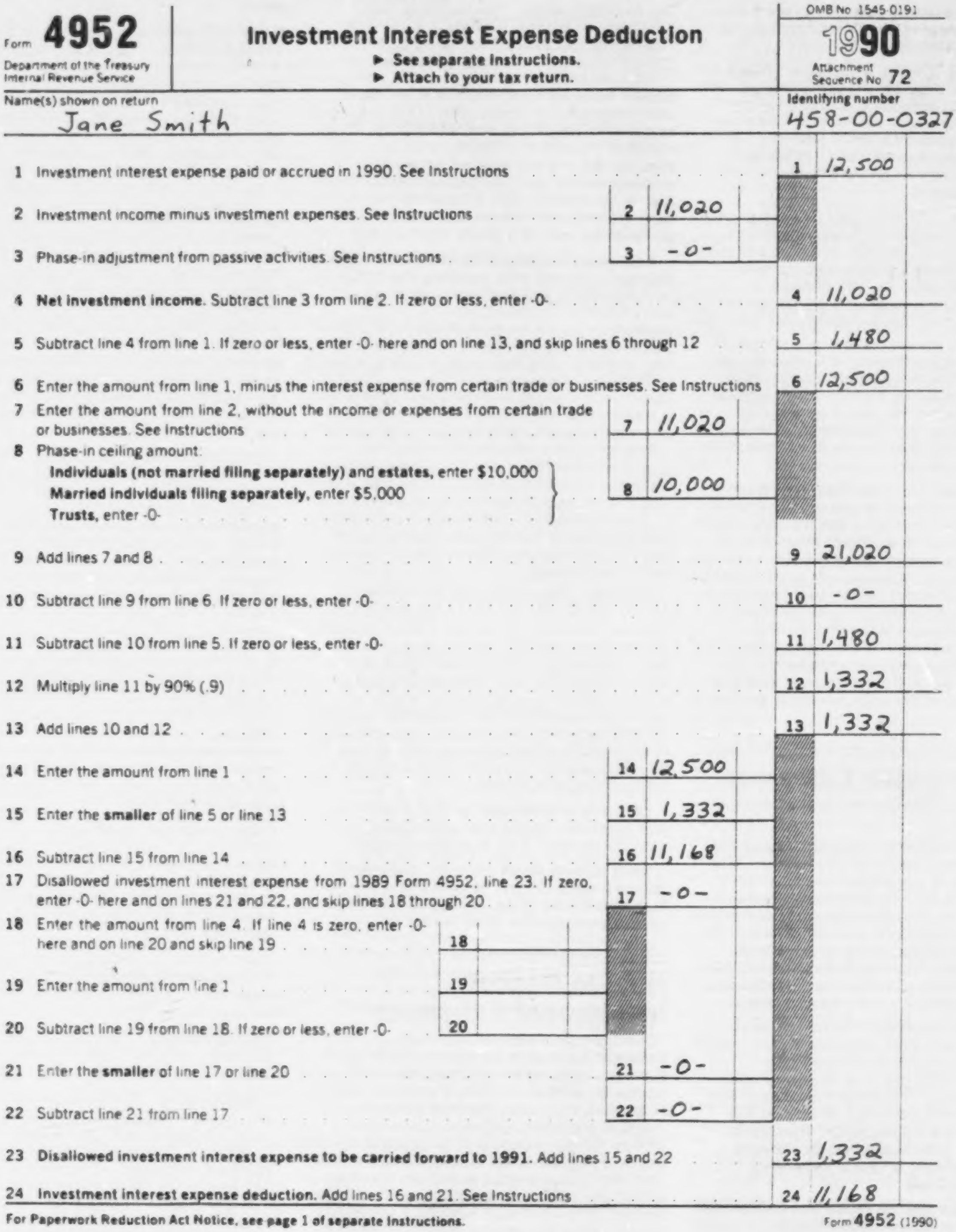
Accrual method. If you use the accrual method, you deduct your expenses when they accrue rather than when you pay them.

Related party. If you use the accrual method, you cannot deduct interest and other expenses owed to a related cash basis person until payment is made and the amount is includible in the gross income of that person. The relationship, for purposes of this rule, is determined as of the end of the tax year for which the interest or expense would otherwise be deductible. If a deduction is denied under this rule, this rule will continue to apply even if your relationship with the person ceases to exist before the amount is includible in the gross income of that person.

The relationships to which this rule applies are identical to those listed later in *Related Party Transactions*.

The postponement of deductions for unpaid expenses and interest under the related party rule does not apply to original issue discount (OID), regardless of when payment is made. This rule also does not apply to loans with below-market interest rates or to payments for the use of property and services when the lender or recipient is required to include payments periodically in income, even though a payment has not been made.

The related party rule, however, does apply to accruals by partnerships to partners, partners to partnerships, shareholders to S corporations, and S corporations to shareholders.



Form **4952**
Department of the Treasury
Internal Revenue Service

Investment Interest Expense Deduction
▶ **See separate instructions.**
▶ **Attach to your tax return.**

OMB No 1545-0191
1990
Attachment Sequence No 72

Name(s) shown on return: Jane Smith
Identifying number 458-00-0327

1	Investment interest expense paid or accrued in 1990. See Instructions					1	12,500
2	Investment income minus investment expenses. See Instructions			2	11,020		
3	Phase-in adjustment from passive activities. See Instructions			3	-0-		
4	**Net investment income.** Subtract line 3 from line 2. If zero or less, enter -0-					4	11,020
5	Subtract line 4 from line 1. If zero or less, enter -0- here and on line 13, and skip lines 6 through 12					5	1,480
6	Enter the amount from line 1, minus the interest expense from certain trade or businesses. See Instructions					6	12,500
7	Enter the amount from line 2, without the income or expenses from certain trade or businesses. See Instructions			7	11,020		
8	Phase-in ceiling amount: **Individuals (not married filing separately) and estates,** enter $10,000 **Married individuals filing separately,** enter $5,000 **Trusts,** enter -0-			8	10,000		
9	Add lines 7 and 8					9	21,020
10	Subtract line 9 from line 6. If zero or less, enter -0-					10	-0-
11	Subtract line 10 from line 5. If zero or less, enter -0-					11	1,480
12	Multiply line 11 by 90% (.9)					12	1,332
13	Add lines 10 and 12					13	1,332
14	Enter the amount from line 1			14	12,500		
15	Enter the **smaller** of line 5 or line 13			15	1,332		
16	Subtract line 15 from line 14			16	11,168		
17	Disallowed investment interest expense from 1989 Form 4952, line 23. If zero, enter -0- here and on lines 21 and 22, and skip lines 18 through 20			17	-0-		
18	Enter the amount from line 4. If line 4 is zero, enter -0- here and on line 20 and skip line 19	18					
19	Enter the amount from line 1	19					
20	Subtract line 19 from line 18. If zero or less, enter -0-	20					
21	Enter the **smaller** of line 17 or line 20			21	-0-		
22	Subtract line 21 from line 17			22	-0-		
23	**Disallowed investment interest expense to be carried forward to 1991.** Add lines 15 and 22					23	1,332
24	**Investment interest expense deduction.** Add lines 16 and 21. See Instructions					24	11,168

For Paperwork Reduction Act Notice, see page 1 of separate Instructions.

Form **4952** (1990)

Sales and Trades of Investment Property

This part explains how you figure your gain or loss when you sell or trade investment property. To determine whether you had a gain or loss on a sale of property, you generally subtract your adjusted basis from the amount you realize. This part includes information on basis, adjusted basis, the difference between a sale and a trade, nontaxable trades, capital gains and losses, and how to report your gain or loss.

Form 1099–B. If you sold property such as securities, commodities, bonds, etc., through a broker, you should receive Form 1099–B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions*, or an equivalent statement from the broker. You should receive the statement by January 31, 1991, showing the gross proceeds from sales during 1990. The IRS will also get a copy of Form 1099–B from the broker.

If you receive a Form 1099–B or equivalent statement, you must complete Schedule D of Form 1040.

Unstated interest and imputed principal rules for sales or exchanges. For information about the unstated interest rules applicable to certain payments received on account of a ***seller-financed*** sale or exchange of property, and about the imputed principal rules applicable to any debt instrument issued on account of such transactions, see Publication 537, *Installment Sales.*

Other property transactions. Certain sales or trades of property are discussed in other IRS publications. These include, for example:

Installment sales, covered in Publication 537;

Transfers of property at death, covered in Publication 559, *Tax Information for Survivors, Executors, and Administrators;* and

Sale of a principal residence, discussed in Publication 523, *Tax Information on Selling Your Home.*

Publication 925 discusses the rules that limit losses and credits from passive activities as well as the rules that apply to the disposition of an interest in a passive activity.

Publication 544, *Sales and Other Dispositions of Assets,* provides information about various types of transactions involving business property, including dispositions of assets used in a trade or business or for the production of income.

Basis of Investment Property

Words you may need to know (see Glossary):

Fair market value
Original issue discount (OID)

Basis is a way of measuring your investment in property for tax purposes. You must know the basis of your property to figure depreciation, amortization, depletion, casualty losses, and whether you have a gain or loss on its sale or other disposition.

Investment property you buy normally has an original basis equal to its cost. If you get property in some way other than buying it, such as by gift or inheritance, its fair market value may be important in figuring the basis.

For more information, see Publication 551, *Basis of Assets.*

Cost Basis

The basis of property you buy is usually its cost. The cost is the money you pay and the fair market value of other property or services you give for it.

Mutual fund load charge. Your basis in shares purchased from a regulated investment company (mutual fund) may include a sales fee, also known as a ***load charge.*** Mutual funds that charge this fee are known as "load funds." A "no-load" mutual fund does not charge this fee. A load charge may give you a ***reinvestment right.***

A load charge is any sales or similar charge you pay to buy shares of a mutual fund. However, it does not include a charge you incur by reason of the reinvestment of a dividend.

A reinvestment right is any right to buy shares of one or more mutual funds at a reduced load charge. A reinvestment right includes the right to reinvest the proceeds from the sale or exchange of shares in the original or another mutual fund.

Load charges incurred after October 3, 1989. For purchases of mutual fund shares after October 3, 1989, you must adjust your basis if you:

1) Incur a load charge and thereby obtain a reinvestment right,
2) Sell those shares within 90 days after the date of purchase, and then
3) Acquire shares in the original or another mutual fund and your load charge is reduced because of your reinvestment right.

Your original load charge, item (1), that increases your basis in your original shares is limited to your reduced load charge for the subsequent acquisition, in item (3). The amount in excess of this limit is treated as a load charge paid on the purchase of the new shares. If these shares are sold within 90 days of their purchase and item (3) applies, then the load charge on these shares will be limited.

Example. On January 4, 1990, Bob purchased shares in XYZ Growth Fund for $10.00 per share. He paid a load charge of 5% ($.50 per share) of the total cost. On February 5, 1990, he sold the shares. Because he had acquired reinvestment rights when he bought the original shares, Bob reinvested the proceeds in the same mutual fund, paying $12.00 per share, within the time limit set by the fund. He paid a reduced load charge of 1% ($.12 per share) for the second transaction.

Bob's basis in the original shares is $10.12 per share. Because he sold the original shares within 90 days of purchase, the original load charge that can be used to increase his basis of the original shares is limited to $.12 (the reduced load charge of the new shares). The remaining $.38 is treated as a load charge paid on the purchase of the new shares. His basis in the new shares is $12.00 per share plus a load charge of $.50 per share (.38 + .12). If he sells these shares within 90 days of their purchase, he will have to recompute this load charge if he acquires new shares at a reduced load charge.

Assuming a mortgage. If you buy property and become liable for an existing mortgage on the property, the cost of the property is the amount you pay plus the unpaid mortgage you assume.

Unstated interest. If you buy property under a deferred-payment plan that charges little or no interest, you may have to treat part of the purchase price as interest. You must subtract this amount, if any, from your cost to find your basis. For more information, see *Unstated Interest* in Publication 537.

Settlement fees. Include certain closing costs, such as real estate agent's commissions and legal and recording fees, in the basis of property. Do not include amounts placed in escrow for the future payment of taxes, insurance, etc.

Real estate taxes. If you buy real property and agree to pay taxes that are owed by the seller, you include the taxes you pay in the cost of the property. You may not deduct them as taxes you paid. If you reimburse the seller for taxes the seller paid for you, you ordinarily may deduct those taxes. Do not include them in the cost of the property.

Basis Other Than Cost

There are times when you must use a basis other than cost. In these cases, the fair market value or the adjusted basis of certain property may be important.

Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts. Sales of similar property, around the same date, may be helpful in figuring fair market value.

If you receive investment property for services, you must include the property's fair market value in income. The basis of the property is the amount you include in income. If the services were performed for a price that was agreed on beforehand, this price will be accepted as the fair market value of the property if there is no evidence to the contrary.

Restricted property. If you receive, as payment for services, property that is subject to certain restrictions, your basis in the property is its fair market value when it becomes substantially vested. Property becomes substantially vested when it becomes transferable or when it is no longer subject to substantial risk of forfeiture. See *Restricted Property Received for Services* in Publication 525 for more information.

Bargain purchases. If you buy investment property from your employer at less than fair market value, as payment for services, you must include the difference in income. Your basis in the property is the price you pay plus the amount you include in income.

Taxable trades. If you traded investment property for other investment property, the basis of the new property is its fair market value at the time of the trade unless you received the property in a nontaxable trade.

Example. You trade A Company stock for B Company stock having a fair market value of $1,200. If the adjusted basis of the A Company stock is less than $1,200, you have a taxable gain on the trade. The basis of the B Company stock is $1,200. If you later sell the B Company stock for $1,300, you will have a gain of $100.

Nontaxable trades. A nontaxable trade is one in which property is traded solely for like property, stock is traded solely for like stock of the same corporation, or property is traded for securities of a controlled corporation. See *Corporate stocks* under *Nontaxable Trades,* later.

Partially nontaxable trade. If you receive unlike property or money in addition to the like property, you may have a taxable gain. However, you are taxed on the gain only to the extent of the money and unlike property you receive.

The basis of property you received in a nontaxable or partially nontaxable trade is generally the adjusted basis of the property you gave up. Increase this amount by any cash you paid, additional costs you had, and any gain recognized. Reduce this amount by any cash or unlike property you received, any loss recognized, any liability of yours that was assumed, and any liability to which the property you traded was subject.

Related parties. Special rules apply to transactions between related parties. See *Related Party Transactions,* later.

Transfers between spouses. Generally, for transfers of property from your spouse, or former spouse if incident to divorce, your basis is your spouse's or former spouse's adjusted basis immediately before the transfer. See *Transfers of property between spouses or incident to a divorce,* later under *Nontaxable Trades.*

Investment property received as a gift. To figure your basis in property that you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its fair market value at the time it was given to you, the amount of any gift tax paid on it, and the date it was given to you.

Fair market value less than donor's adjusted basis. If the fair market value of the property at the time of the gift was less than the adjusted basis to the donor just before the gift, your basis for ***gain*** on its sale or other disposition is the same as the donor's adjusted basis. Your basis for ***loss*** is its fair market value at the time of the gift.

No gain or loss. If you use the basis for figuring a gain and figure a loss, and then use the basis for figuring a loss and figure a gain, you will have neither a gain nor a loss.

Example. You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. You have neither gain nor loss. Your basis for figuring gain is $10,000, and $10,000 minus $9,500 results in a $500 loss. Your basis for figuring loss is $9,000, and $9,500 minus $9,000 results in a $500 gain.

Fair market value more than donor's adjusted basis. If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift, your basis for ***gain or loss*** on its sale or other disposition is the donor's adjusted basis at the time of the gift. You may be allowed to add to the donor's adjusted basis all or part of any gift tax paid, depending on the date of the gift.

Gift received before 1977. If you received property as a gift before 1977, your basis in the property is the donor's adjusted basis increased by the total gift tax paid on the gift. However, your basis cannot be more than the fair market value of the gift at the time it was given to you.

Example 1. You were given XYZ Company stock in 1976. At the time of the gift, the stock had a fair market value of $21,000. Its adjusted basis to the donor was $20,000. The donor paid a tax of $500 on the gift. Your basis for gain or loss is $20,500, the donor's adjusted basis plus the amount of gift tax paid.

Example 2. Assume the same facts as in Example 1 except that the gift tax paid was $1,500. Your basis is $21,000, the donor's adjusted basis plus the gift tax paid, but limited to the fair market value of the stock at the time of the gift.

Gift received after 1976. If you received property as a gift after 1976, your basis is the donor's adjusted basis increased by the part of the gift tax paid that is for the net increase in value of the gift. You figure this part by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) is the net increase in value of the gift and the denominator (bottom part) is the fair market value of the gift.

The net increase in value of the gift is the fair market value of the gift minus the donor's adjusted basis.

Example. In 1990, you received a gift of property from your mother. At the time of the gift, the property had a fair market value of $100,000 and an adjusted basis to her of $40,000. She paid a gift tax of $9,000 on the property. You figure your basis in the following way:

Fair market value	$100,000
Minus: Adjusted basis	40,000
Net increase	$ 60,000

Gift tax paid	$ 9,000
Multiplied by .60 ($60,000 ÷ $100,000)	.60
Gift tax due to net increase in value	$ 5,400
Plus: Adjusted basis of property to your mother	40,000
Your basis in the property	**$ 45,400**

Note: If the donee pays the gift tax, the donor realizes taxable income to the extent the gift taxes paid by the donee exceed the donor's adjusted basis in the property.

Part sale, part gift. If you get property in a transaction that is partly a sale and partly a gift, your basis is either the basis of the gift, as explained here, or the amount you paid for the property, whichever is greater.

Inherited investment property. If you inherited property, your basis in that property generally is its fair market value on the date of the decedent's death or the later alternate valuation date if the estate qualifies for, and elects to use, alternate valuation. If no federal estate tax return was filed, use the appraised value on the date of death for state inheritance or transmission taxes.

The basis in certain appreciated property that you acquire may be the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies only if you or your spouse had given the decedent the appreciated property as a gift during the one-year period ending on the date of death. Appreciated property is any property whose fair market value on the day it was given to the decedent is more than its adjusted basis.

Stocks and Bonds

The cost basis of stocks or bonds is the purchase price plus the costs of purchase such as commissions and recording or transfer fees. If you acquired stock or bonds other than by purchase, your basis is usually determined by fair market value or the donor's adjusted basis. The basis must be adjusted for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, you must reduce the basis of your original stock. You must also reduce your basis when you receive nontaxable distributions because these are a return of capital.

If you can definitely identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stock or bonds. However, if you buy and sell securities at various times in varying quantities and you cannot definitely identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. Except for certain mutual fund shares, discussed later, you may not use the average price per share to figure gain or loss on the sale of the shares.

Example. You bought 100 shares of stock of XYZ Corporation in 1983 for $10 a share. In January 1984 you bought another 200 shares for $11 a share. In July 1984 you gave your son 50 shares. In December 1986 you bought 100 shares for $9 a share. In April 1990 you sold 130 shares. You cannot identify the shares you disposed of, so you must use the stock you acquired first to figure the basis. The shares of stock you gave your son had a basis of $500 (50 × $10). You figure the basis of the stock you sold in 1990 as follows:

50 shares (50 × $10) balance of stock bought in 1983	$ 500
80 shares (80 × $11) stock bought in January 1984	880
Total basis of stock sold in 1990	**$1,380**

Identification. You will make an adequate identification if you show that certificates representing shares of stock from a lot that you bought on a certain date or for a certain price were delivered to your broker or other agent.

If you have left the stock certificates with your broker or other agent, an adequate identification is made if you:

1) Tell your broker or other agent the particular stock to be sold or transferred at the time of the sale or transfer, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

If you bought stock in different lots at different times and you hold a single stock certificate for this stock, you will make an adequate identification if you:

1) Tell your broker or other agent the particular stock to be sold or transferred when you deliver the certificate to your broker or other agent, and
2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

Stock identified this way is the stock sold or transferred even though stock certificates from a different lot are delivered to the broker or other agent. If you sell part of the stock represented by a single certificate directly to the buyer instead of through a broker, you will make an adequate identification if you keep a written record of the particular stock that you intend to sell. This method of identification also applies to bonds sold or transferred.

Mutual fund shares. You can choose to use the average basis of shares you own in a regulated investment company (mutual fund), if you acquired the shares at various times and prices, and if you left the shares on deposit in an account kept by a custodian or agent for acquiring or redeeming such shares. You figure average basis by using either the double-category method or the single-category method. These methods and other information on the basis of mutual fund shares are explained in Publication 564.

Automatic investment service. If you participate in an automatic investment service, your cost basis for each share of stock, including fractional shares, bought by the bank or other agent is the cost price plus a share of the brokerage commission.

In determining your holding period for shares bought by the bank, it is assumed that full shares were bought first and any fractional shares were bought last. Your holding period starts on the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

Dividend reinvestment plans. If you participate in a dividend reinvestment plan and receive stock from the corporation at a discount, your cost is the full fair market value of the stock on the dividend payment date. You must include the amount of the discount in your income.

Public utilities. If, before 1986, you excluded from income the value of stock you had received under a qualified public utility reinvestment plan, your basis in that stock is zero. See *Public utility stock reinvestment plans* under *Dividends and Other Corporate Distributions,* earlier.

Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable to you. However, see *Nontaxable Distributions* under *Dividends and Other Corporate Distributions,* earlier. If the stock dividends are not taxable, you must divide your basis for the stock between the old and new stock.

New and old stock identical. If the new stock you received as a nontaxable dividend is identical to the old stock on which the dividend is declared, divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is your basis for each share of stock.

Example. You owned one share of common stock that you bought for $45. The corporation distributed two new shares of common stock for each share held. You then had three shares of common stock. Your basis of each share is $15 ($45 ÷ 3). If you owned two shares before the distribution, one bought for $30 and the other for $45, you would have six shares after the distribution—three with a basis of $10 each and three with a basis of $15 each.

New and old stock not identical. If the new stock you received as a nontaxable dividend is not identical to the old stock on which it is declared, divide the adjusted basis of the old stock between the old and the new stock in the ratio of the fair market value of each lot of stock to the total fair market value of both lots on the date of distribution of the new stock.

Example. You bought a share of common stock for $100. Later, the corporation distributed a share of preferred stock for each share of common stock held. At the date of distribution, your common stock had a fair market value of $150 and the preferred stock had a fair market value of $50. You figure the basis of the old and new stock by dividing your $100 basis between them. The basis of your common stock is $75 ($150/$200 × $100) and the basis of the new preferred stock is $25 ($50/$200 × $100).

Stock bought at various times. Figure the basis of stock dividends received on stock you bought at various times and at different prices by allocating to each lot of stock the share of the stock dividends attributable to it.

Stock splits. Figure the basis of stock splits in the same way as stock dividends if identical stock is distributed on the stock held.

Your holding period for new stock that you receive as a nontaxable stock dividend begins on the same date as the holding period of the old stock.

If your stock dividend is taxable when you receive it, the original basis of your new stock is its fair market value on the date of distribution. The basis of your old stock does not change. Your holding period is determined from the date of distribution.

Stock rights. A stock right is a right to subscribe to a new issue of a corporation's stock. It may be exercised, sold if it has a market value, or expire. Stock rights are rarely taxable when you receive them. See *Nontaxable Distributions* under *Dividends and Other Corporate Distributions*, earlier.

If you receive stock rights that are taxable, the basis of the rights is their fair market value at the time of distribution. The basis of the old stock does not change.

If you receive nontaxable stock rights and allow them to expire, they have no basis.

If you exercise or sell the nontaxable stock rights and if, at the time of distribution, the stock rights had a fair market value of 15% or more of the fair market value of the old stock, you must divide the adjusted basis of the old stock between the stock and the stock rights. Use a ratio of the fair market value of each to the total fair market value of both at the time of distribution.

If the fair market value of the stock rights is less than 15%, their basis is zero. However, you can choose to divide the basis of the old stock between the old stock and the stock rights. To make the choice, attach a statement to your return for the year in which you receive the rights stating that you choose to divide the basis of the stock.

Basis of new stock. If you exercise the stock rights, the basis of the new stock is its cost plus the basis of the stock rights exercised. The holding period of the new stock begins on the date you exercised the stock rights.

Example. You own 100 shares of ABC Company stock, which cost you $22 per share. The ABC Company gave you 10 stock rights that would allow you to buy 10 additional shares at $26 per share. At the time the stock rights were distributed, the stock had a market value of $30, not including the stock rights. Each stock right had a market value of $3. The market value of the stock rights was less than 15% of the market value of the stock, but you chose to divide the basis of your stock between the stock and the rights. You figure the basis of the rights and the basis of the old stock as follows:

100 shares × $22 = $2,200, basis of old stock

100 shares × $30 = $3,000, market value of old stock

10 rights × $3 = $30, market value of rights

($3,000 ÷ $3,030) × $2,200 = $2,178.22, new basis of old stock

($30 ÷ $3,030) × $2,200 = $21.78, basis of rights

If you sell the rights, the basis for figuring gain or loss is $2.178 per right. If you exercise the rights, the basis of the stock you acquire is the price you pay ($26) plus the basis of the right exercised ($2.178), or $28.178 per share. The remaining basis of the old stock is $21.78 per share.

The holding period of nontaxable stock rights begins on the same date as the holding period of the original stock.

Scrip dividends. A scrip dividend is a temporary certificate entitling its holder to a fractional share of stock. Scrip dividends are generally taxable to the extent of their fair market value when you receive them. Basis for scrip is its market value on the date of receipt.

Investment property received in liquidation. In general, if you receive investment property as a distribution in partial or complete liquidation of a corporation and if you recognize gain or loss when you acquire the property, your basis in the property is its fair market value at the time of the distribution.

S corporation stock. You must ***increase*** your basis in stock of an S corporation by your pro rata share of the following items:

All income items of the S corporation that are separately stated,

The nonseparately stated income of the S corporation, and

The amount of the deduction for depletion that is more than the basis of the property being depleted.

You must ***decrease*** your basis in stock of an S corporation by your pro rata share of the following items:

Distributions by the S corporation that are a return of basis,

All loss and deduction items of the S corporation that are separately stated and passed through to you,

Any nonseparately stated loss of the S corporation,

Any expense of the S corporation that is not deductible in figuring its income and not properly chargeable to a capital account, and

The amount of your deduction for depletion of oil and gas wells.

However, your basis in the stock cannot be reduced below zero. See Publication 589 for more information.

Premiums on bonds. If you buy a taxable bond at a premium and choose to amortize the premium paid, you must reduce the basis of the bond by a part of the premium each year over the life of the bond. If you do not choose to amortize the bond premium, the premium is treated as part of your basis in the bond.

Although you may not deduct the premium on tax-exempt bonds, you must amortize it. You must reduce the basis of the bonds by the premium you amortized for the period you held the bonds.

See *Bond Premium Amortization*, earlier, for more information.

Market discount on bonds. If you include market discount on a bond in income currently, increase the basis of your bond by the amount of market discount you include in your income.

Acquisition discount on short-term obligations. If you include acquisition discount on a short-term debt obligation in your income currently, increase the basis of the obligation by the amount of acquisition discount you include in your income.

Original issue discount (OID) on debt instruments. If you include in your income an amount of OID on corporate instruments issued after May 27, 1969, or on certain noncorporate instruments issued after July 1, 1982, increase the basis of the instruments by this amount. See *Original Issue Discount (OID)*, earlier, and *Discounted debt instruments*, later, under *Capital or Ordinary Gain or Loss*.

Discounted tax-exempt obligations. OID on tax-exempt obligations is generally not taxable. However, before you dispose of a tax-exempt obligation issued after September 3, 1982, that you acquire after March 1, 1984, you must accrue OID on the obligation to determine its adjusted basis. The accrued OID is added to the basis of the obligation to determine any gain or loss when you dispose of it.

You must accrue OID on a tax-exempt obligation under the same method used for OID on corporate debt instruments issued after July 1, 1982. For information about determining OID, see *Debt Instruments Issued After July 1, 1982, and Before January 1, 1985*, or *Debt Instruments Issued After December 31, 1984*, as applicable, in Publication 1212.

If the tax-exempt obligation has a maturity of one year or less, accrue OID under the rules for acquisition discount on ***short-term obligations***. See *Discount on Short-Term Obligations*, earlier.

Stripped tax-exempt obligation. For any stripped tax-exempt bond or coupon that you buy or sell after October 22, 1986, you must accrue OID on that obligation to determine its adjusted basis when you dispose of it. For stripped tax-exempt bonds or coupons bought or sold after June 10, 1987, part of this OID may be taxable. You accrue the OID on such obligations in the manner described earlier under *Stripped Bonds and Coupons*.

Increase your basis in the stripped tax-exempt bond or coupon by the interest that accrued but was not paid, and not previously reflected in your basis, before the date you sold the bond or coupon. In addition, for bonds bought or sold after June 10, 1987, add to your basis any accrued market discount (the taxable part of the OID) not previously reflected in basis.

Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property, or figure allowable depreciation, depletion, or amortization, you usually must make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to basis. You increase the basis or cost of your property by all items that are charged to a capital account. These include:

The cost of improvements and betterments having a life of more than one year,

Purchase commissions,

Title insurance costs,

Legal fees for defending and perfecting title,

Assessments levied against the property to pay for local benefits,

Legal fees for getting the assessment reduced,

Certain carrying charges,

State and local transfer taxes you pay when you buy or sell securities, and

All other capital expenses.

You cannot increase your basis in property for expenses that are deductible as current expenses. However, you can choose to capitalize certain taxes, interest, commitment fees, carrying charges, etc. If you make this choice, add these items to the basis of the property.

Short sales. No deduction is allowed for payments you make to a lender in lieu of dividends distributed during the time you maintain a short position on stock used in a short sale, if the closing occurs on or before the 45th day after the date of the short sale (one year in the case of extraordinary dividends).

The 45-day and one-year periods are suspended during any period in which you hold options to buy substantially identical stock or securities or hold one or more positions in substantially similar or related property.

The amount you pay to the lender for dividends distributed during the time you maintained your short position is a capital expense, and you must add it to the basis of the stock sold short.

See *Short Sales,* later under *Capital or Ordinary Gain or Loss* for more information.

Mutual fund stock. If you own stock in a mutual fund, you must report as capital gains any amounts that the fund allocated to you as capital gain distributions, even though you did not actually receive them. Increase your basis in the fund by the difference between the undistributed capital gain included in income and the amount of tax paid for you by the fund. See *Undistributed capital gains* under *Capital Gain Distributions,* earlier.

Decreases to basis. You must reduce your original basis by receipts that are a return of capital, such as nontaxable distributions. Other items that reduce basis include:

Depreciation allowed or allowable,

Depletion,

Losses recognized on involuntary conversions,

Deducted casualty losses, and

Insurance reimbursements.

However, you cannot reduce your basis below zero.

What is a Sale or Trade?

A sale is generally a transfer of property for money only or for a promise to pay money, such as a mortgage or note. A trade is a transfer of property in return for other property or services, and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. Such a sale and purchase are two separate transactions.

A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend vs. sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1) The redemption is not essentially equivalent to a dividend (see *Dividends and Other Corporate Distributions* earlier),
2) There is a substantially disproportionate redemption of stock,
3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4) The redemption is a distribution in partial liquidation of a corporation.

A redemption or retirement of bonds or notes at their maturity is a sale or trade which you must report on Schedule D (Form 1040) whether or not you realize gain or loss on the transaction.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

A surrender of stock by a dominant shareholder, who retains control of the corporation, is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Trade of investment property for an annuity. If you transfer investment property to an organization, such as a corporation, trust, fund, or foundation, in exchange for a contract providing for a fixed annuity to pay you guaranteed annual payments for life, you realize a gain if the present value of the annuity is more than your basis in the property traded. This gain is taxable in the year of the trade. Figure the present value of the annuity according to factors used by commercial insurance companies issuing annuities.

The transfer of property of a decedent to the executor or administrator of the estate, or to the heirs or beneficiaries, is not a sale or other disposition. No taxable gain or deductible loss results from the transfer.

How to Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain is the amount you realize from a sale or trade minus the adjusted basis of the property you transfer.

Loss is the adjusted basis of the property minus the amount you realize.

The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other evidenc of indebtedness you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of such debt instruments.

An indebtedness against the property, or against you, that is paid off as a part of the transaction or that is assumed by the buyer must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade propert that is subject to a nonrecourse loan, the amount you realize includes the full amount of the note assumed by the buyer even though the amount o the note exceeds the fair market value of the property.

Payment of cash. If you trade property for other property and in addition pay cash, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting your adjusted basis (the cash you pay and the adjusted basis of the property you traded in) from the amount you realize.

Example 1. You sell stock which you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 plus $8,000). Your gain is $22,000 ($28,000 minus $6,000).

Example 2. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 minus $7,000). If you also receive a note for $6,000 that has a discount value of $4,000, your gain is $7,000 ($10,000 plus $4,000 minus $7,000).

No gain or loss. You may be required to use a basis for figuring gain different from that used for figuring loss. In this case, you may not have a gai or a loss. See *No gain or loss* under *Basis Other Than Cost,* earlier.

Nontaxable Trades

The following trades generally do not result in a taxable gain or a deductible loss. However, gain on the trade of depreciable property for other property or for stock, and gain on the involuntary conversion of depreciable property, may be taxed For more information, see Publication 544.

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you must postpone tax on the gain or postpone deducting the loss until you sell or dispose of the property you receive. All six of the following requirements must be met for the trade to be nontaxable.

1) The property must be business or investment property. You must hold both the property yo trade and the property you receive for business or investment purposes. Neither propert may be used for personal purposes, such as your home or family car.
2) The property must not be property held for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for productive use in your trade or business or property held for investment.
3) There must be an exchange of like-kind property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges o like-kind property. The trade of an apartment house for a store building, or a panel truck fo a pickup truck, are like-kind exchanges. The exchange of a piece of machinery for a store building is not a like-kind exchange.

4) The property must be tangible property. These rules and benefits do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest, including the exchange of partnership interests. However, you may have a nontaxable exchange of corporate stocks, as discussed later.

5) The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date of transfer of the property given up in the exchange.

6) The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:
   a) The 180th day after the date on which you transfer the property given up in the transfer, or
   b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you receive cash or nonlike-kind property in addition to the like-kind property, and the above conditions are met, you have a partially nontaxable trade. You are taxed on the gain you realize, but only to the extent of the cash and the fair market value of the nonlike-kind property you receive. You may not deduct a loss.

If you pay money in addition to transferring property in exchange for like-kind property, you have no taxable gain or deductible loss.

If you give up nonlike-kind property in addition to the like-kind property, you must recognize gain or loss only on the nonlike-kind property you give up. The gain or loss is the difference between the adjusted basis of the nonlike-kind property and its fair market value.

How to report. You must report the exchange of business or investment like-kind property on Schedule D of Form 1040 (or **Form 4797,** *Sales of Business Property,* whichever applies) and on Form 8824, *Like-Kind Exchanges.*

For exchanges reported on Schedule D, write "From Form 8824" in column (a). Skip columns (b) through (e), and enter the gain or loss from Form 8824, if any, in column (f) or (g). (See *Reporting Capital Gains and Losses on Schedule D,* later, to determine whether to use line 2a, 2d, 9a, or 9d.) At the top of Schedule D, write the words "Like-Kind Exchange" or, if one or more exchanges involved a related party, write "Related Party Like-Kind Exchange."

To compute any partial gains or losses and for more information on like-kind exchanges, see the instructions for Form 8824. For more information on how to report the sale of business property, see Publication 544.

Rule for foreign real property. Generally, for transfers after July 10, 1989, the trade of real property located in the United States for real property located outside the United States is not a like-kind exchange.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two persons as well as a trade between a stockholder and a corporation.

In some instances, you may trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

Convertible stocks and bonds. You will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate except where gain is specifically required to be recognized.

Example. In November, you bought for $1 a right issued by XYZ Corporation entitling you, on payment of $99, to subscribe to a debenture issued by that corporation.

On December 2, you subscribed to the debenture that was issued on December 9. The debenture contained a clause stating that you would receive one share of XYZ Corporation common stock on surrender of one debenture and the payment of $50. You presented the debenture and $50 and received one share of XYZ Corporation common stock.

You do not have a recognized gain or loss when you surrender the debenture and $50 for the share of common stock. This is true whether the fair market value of the stock was more or less than $150 on the date of the conversion.

The basis of your share of stock is $150. Your holding period is split. Your holding period for the part of the share of stock attributable to your ownership of the debenture ($100 basis) begins on December 2. Your holding period for the part of the share of stock attributable to your cash investment ($50 basis) begins on the day after you acquire the share of stock.

Note: Generally, if you convert the bonds of one corporation into common stock of another corporation, according to the terms of the bond issue, you must recognize gain or loss on the exchange to the extent of the difference between the fair market value of the common stock received and the cost or other basis of the bonds exchanged. In some instances, however, such as trades that are part of mergers or other corporate reorganizations, you will have no recognized gain or loss if certain requirements are met. If you want more information about the tax consequences of converting securities of one corporation into common stock of another corporation, under circumstances such as those just described, consult the respective corporations and the terms of the bond issue.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company. However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for more information.

If you are in a bankruptcy or a similar proceeding and you transfer assets to a controlled corporation under a plan, other than a reorganization, you must recognize gain to the extent the stock you receive in the exchange is used to pay off your debts.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you must file a complete statement of all facts pertinent to the exchange with your return.

Money or other property. If, in an otherwise nontaxable trade of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. However, you are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring gain in this situation generally follow those discussed earlier for like-kind exchanges. No loss is recognized.

Insurance policies and annuities. You will not have a recognized gain or loss if you trade:

1) A life insurance contract for another life insurance contract or for an endowment or an annuity contract,

2) An endowment contract for an annuity contract, or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or

3) An annuity contract for another annuity contract.

The insured or annuitant must stay the same as under the original contract. Exchanges of these contracts that are not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade. The Treasury will mail a check for the final interest, regardless of whether your maturing securities are used to purchase new Treasury securities or are presented for cash payment. However, if you purchased a new issue through the TREASURY DIRECT system, such payments will be credited to your designated account by direct deposit. See the earlier discussion under *U.S. Treasury Bills, Notes, and Bonds,* for more information about income from these investments. For other information on these notes or bonds, write to:

Bureau of the Public Debt
U.S. Department of the Treasury
Washington, D.C. 20239–1000

Transfers of property between spouses or incident to a divorce. Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the transferee as acquired by gift and is not considered a sale or exchange. The transferee's basis in the property will be the same as the adjusted basis of the transferor immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. For more information, see Publication 504, *Tax Information for Divorced or Separated Individuals.*

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Gain on Sale or Trade of Depreciable Property

If you have a recognized gain on the sale or trade of property, including a leasehold or a patent application, that is depreciable property in the hands of the party who receives it, the capital gain provisions do not apply and the gain is ordinary income if the transaction is between you and a controlled entity, or you and a trust in which you or your spouse is a beneficiary. See Publication 544 for more information.

Like-Kind Exchanges

Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges,* discussed earlier under *Nontaxable Trades.*

This rule applies to exchanges of property between related parties, defined next under *Loss on Sale or Trade of Property.* However, if either related person disposes of the like-kind property within 2 years after the exchange, the gain or loss on the exchange must be recognized. Each related person must report any gain or loss not recognized on the original exchange on the tax return filed for the year in which the later disposition occurred. This rule applies to all transfers after July 10, 1989, except those made under binding contracts in effect on that date and up to the time of transfer.

These rules generally ***do not apply*** to:

Dispositions due to the death of either related person,

Involuntary conversions (see Publication 544), or

Exchanges or dispositions whose main purpose is not the avoidance of federal income tax.

The 2-year period does not include the period during which the holder's risk of loss is substantially diminished by:

The holding of a put on the property,

The holding by another person of a right to acquire the property, or

A short sale or any other transaction.

Loss on Sale or Trade of Property

You may not deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following ***related parties:***

1) Members of your family—this includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.),
2) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock. See *Constructive ownership of stock* (which follows), or
3) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties:

1) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust,
2) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts,
3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned, by or for the trust, or by or for the grantor of the trust,
4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership,
5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation, or
7) Two corporations that are members of the same controlled group (under certain conditions, however, such losses are not disallowed but must be deferred).

If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Investment expenses. The same related parties identified in the preceding lists must also be considered when you determine the deductibility of investment expenses under the accrual method. See *How to Report Investment Expenses,* earlier, for more information about the related party rule.

Indirect transactions include sales through a stock exchange. You cannot deduct your loss on the sale of stock through your broker if, for example, under a prearranged plan a related party or entity buys the same stock you had owned.

Constructive ownership of stock. In determining whether a person ***directly or indirectly*** owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. Stock constructively owned by a person under rule 1 for applying rule 1, 2, or 3 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or 3 is not treated as owned by that individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent that it is more than the loss previously disallowed to the transferor. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the transferor's loss was disallowed because of the wash sale rules, described later under *Wash Sales.*

Example 1. Your brother sells you stock with a cost basis of $10,000 for $7,600. Your brother cannot deduct the loss of $2,400. Later you sell the same stock to an unrelated party for $10,500, thus realizing a gain of $2,900. Your reportable gain is $500—the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2. If, in Example 1, you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700—$7,600 basis minus $6,900. You cannot deduct the loss that was not allowed to your brother.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a ***capital asset.*** Some examples are stocks or bonds held in your personal account, a house owned and used by you and your family, household furnishings, a car used for pleasure or commuting, coin or stamp collections, gems and jewelry, gold, silver, or any other metal.

Capital assets do not include:

1) ***Property held mainly for sale to customers*** or property that will physically become a part of the merchandise that is for sale to customers,
2) ***Depreciable property*** used in your trade or business, even though fully depreciated,
3) ***Real property*** used in your trade or business,
4) ***A copyright, a literary, musical, or artistic composition, a letter or memorandum,*** or similar property that you created by your personal efforts; that was prepared or produced for you (in the case of a letter, memorandum, or similar property); or that you acquired under circumstances (for example, by gift) entitling you to the basis of a person who created the property or for whom it was prepared or produced,
5) ***Accounts or notes receivable*** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1), and
6) ***U.S. Government publications*** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.

Noncapital assets. Noncapital assets include the six items listed above as exceptions to capital assets.

Capital or Ordinary Gain or Loss

Words you may need to know (see Glossary):

Call
Commodity future
Equity option
Extraordinary dividend
Forward contract
Hedging transaction
Limited partner
Listed option
Marked to market
Nonequity option
Options dealer
Put
Regulated futures contract
Section 1256 contract
Straddle
Wash sale

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

The tax treatment of gains and losses from several types of transactions is discussed in this part.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions are essential to correctly arrive at your net capital gain or loss. The correct classification of your gains and losses is important for determining the limit on capital losses. For information about determining whether your gain or loss was a short-term or long-term capital gain or loss, see the discussion under *Holding Period,* later. For more information about figuring your capital gain income and determining your allowable capital losses, see *Reporting Capital Gains and Losses on Schedule D,* later.

Investment Property

Investment property is a capital asset. Any gain or loss you have from its sale or trade generally is a capital gain or loss.

Gold, silver, stamps, coins, gems, etc., are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds, including stock received as a dividend, are capital assets except when they are held for sale by a securities dealer. However, see *Losses on Small Business Stock* and *Losses on Small Business Investment Company Stock,* later in this publication.

Worthless securities. Stocks, stock rights, and corporate or government bonds with interest coupons or in registered form, which became worthless during the tax year, are treated as though they were capital assets sold on the last day of the tax year if they were capital assets in your hands. To determine whether they are long-term or short-term capital assets, you are considered to have held the stocks or securities until the last day of the year in which they became worthless. See *Holding Period,* later.

If you are a cash method taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

Discounted debt instruments. Treat your gain or loss on the sale, redemption, or retirement of a bond or other evidence of indebtedness originally issued at a discount as follows.

Treat gains on ***short-term federal, state, or local government obligations*** as ordinary income up to the ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than one year from the date of issue. (However, this treatment does not apply for state or local government obligations with tax-exempt interest.) Any gain in excess of the ratable share of the acquisition discount is capital gain. Any loss is capital loss. ***Acquisition discount*** is the excess of the stated redemption price at maturity over your basis in the obligation.

However, do not treat such gains as income to the extent you previously included the discount in income. This amount increases your basis in the obligation. See *Discount on Short-Term Obligations,* earlier, for more information.

Treat gains on ***short-term nongovernmental obligations*** (whether or not tax exempt) as ordinary income up to the ratable share of OID. This treatment applies to obligations that are not short-term governmental obligations, and that have a fixed maturity date of not more than one year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. This amount increases your basis. See *Discount on Short-Term Obligations,* earlier, for more information.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, and you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. Do not include it in income. However, any gain from market discount is taxable as a capital gain on disposition or redemption of tax-exempt bonds. You figure market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

For the treatment of basis at the time of disposition of tax-exempt state and local government bonds issued after September 3, 1982, and acquired after March 1, 1984, see *Discounted tax-exempt obligations* under *Stocks and Bonds,* earlier.

Long-term debt instruments issued after 1954, and before May 28, 1969 (or before July 2, 1982, if a government issue). If you sell, exchange, or redeem for a gain one of these debt instruments, the part of your gain due to the OID is interest income at the time of sale or redemption. The balance of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, the entire amount of OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter. See *Original Issue Discount (OID),* earlier.

Example 1. You bought a 10–year, 6% government bond for $900 at original issue on April 1, 1982, and sold it on April 20, 1990, for $950. The redemption price is $1,000. At the time of original issue there was no intention to call the bond before maturity. You have held the bond for 96 full months. Do not count the additional days that are less than a full month. The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction 96/120 multiplied by the discount of $100 is equal to $80. This is your OID for the period you owned the bond. You must treat any part of the gain up to $80 as ordinary income. Therefore, your $50 gain is treated as ordinary income.

Example 2. If, in Example 1, you sold the bond for $990, you would have a gain of $90: of that, $80 is ordinary income and $10 is long-term capital gain.

Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982. If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in that debt instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID),* earlier.

If you sell or exchange the debt instrument before maturity, your gain on the sale is a capital gain, provided the debt instrument was a capital asset. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain on the sale of the instrument is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, any balance of the gain is a capital gain.

Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument.

Example 1. On February 2, 1988, you bought at original issue for $7,600, Jones Corporation's 10–year, 5% bond which has a stated redemption price at maturity of $10,000. On February 1, 1990, you sell the bond to Susan Green for $9,040. Assume you have included $480 of the OID in your gross income and increased your basis in the bond by that amount. This includes the amount accrued for 1990. Your basis is now $8,080. If at the time of the original issue there was no intention to call the bond before maturity, your gain of $960 ($9,040 amount realized minus $8,080 adjusted basis) is a long-term capital gain.

Example 2. If, in Example 1, at the time of original issue there was an intention to call the bond before maturity, you will include the entire gain as ordinary income. You figure this as follows:

1) Entire OID ($10,000 stated redemption price at maturity minus $7,600 issue price)	$2,400
2) Minus: Amount previously included in income	480
3) Maximum amount includible by you as ordinary income	$1,920

Because the amount in (3) is more than your gain of $960, you must include your entire gain as ordinary income.

Notes of individuals. If the evidence of indebtedness you bought at a discount was issued by an individual, its retirement generally will not be given capital gain treatment. But, if you sell the discounted obligation to someone other than the original borrower, the gain is a capital gain as long as it was not acquired in the ordinary course of your trade or business for services rendered or from the sale of inventory. In figuring your adjusted basis in the note, do not reduce your original basis by any interest payments or by the part of the principal payments you received that is taxable discount income.

Example. You bought a note of an individual for $6,000 on which $10,000 was still owed. You receive principal payments totaling $4,000. Then you sell the note for $3,800. Only 60% ($6,000/$10,000) of the $4,000 is a return of your investment. The balance is discount income. You reduce your cost by $2,400 ($4,000 × 60%) to figure your adjusted basis. You figure your capital gain in the following way:

Selling price of note		$3,800
Minus adjusted basis of note:		
Cost of note	$6,000	
Minus return on investment	2,400	3,600
Capital gain		$ 200

The OID rules discussed earlier under *Original Issue Discount (OID)* apply to obligations issued by individuals after March 1, 1984. The OID rules will not apply to loans between individuals in amounts of $10,000 or less (including the outstanding amounts of prior loans) if the lender is not in the business of lending money, except if a principal purpose of the loan is to avoid federal tax.

Obligations issued in bearer form. Generally, any loss on a registration-required obligation held in bearer form is not deductible and any gain on the sale or other disposition of such obligation is ordinary income, unless the issuer was subject to a tax on the issuance of the obligation.

A registration-required obligation is any obligation except an obligation:

1) That is issued by a natural person.
2) That is not of a type offered to the public.
3) That has a maturity at the date of issue of not more than 1 year.
4) That was issued before 1983.

Loss on deposits in an insolvent or bankrupt financial institution. If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed below) in that year.

If you claim a casualty loss, attach **Form 4684,** *Casualties and Thefts*, to your return. Each loss must be reduced by $100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on Schedule A (Form 1040). The maximum amount you can claim is $20,000 ($10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2% of adjusted gross income limit. You cannot choose to claim an ordinary loss if any part of the deposit is federally insured.

You cannot choose either of these methods if:

You own at least 1% of the financial institution,

You are an officer of the institution, or

You are related to such an owner or officer.

If the actual loss that is finally determined is more than the amount deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed. See *Recoveries* in Publication 525.

Sale of annuity. The part of any gain on the sale of an annuity contract before its maturity date that is attributable to interest accumulated on the contract is ordinary income.

Nonbusiness Bad Debts

There are two kinds of bad debts—business bad debts and nonbusiness bad debts. A business bad debt, generally, is one that comes from operating your trade or business. All other bad debts are nonbusiness bad debts.

Example. An architect made personal loans to several friends who were not clients. She could not collect on some of these loans. They are deductible only as nonbusiness bad debts, since the architect was not in the business of lending money and the loans do not have any relationship to the architect's business.

Deductible nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

When deductible. You may take a bad debt deduction only in the year the debt becomes ***worthless.*** You do not have to wait until a debt is due to determine whether it is worthless. A debt becomes worthless when there is no longer any chance of being paid what you are owed.

It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You must only show that you have taken reasonable steps to collect the debt. Bankruptcy of your debtor is generally good evidence of the worthlessness of at least a part of an unsecured and unpreferred debt.

If your bad debt is the loss of a deposit in a financial institution, see *Loss on deposits in an insolvent or bankrupt financial institution*, earlier under *Investment Property*.

Loan or gift. If you lend money to a relative or friend with the understanding that it is to be repaid, but you later forgive the debt, it is considered a gift, and not a loan. You cannot take a bad debt deduction for a gift. There must be a true creditor-debtor relationship between you and the person or organization that owes you the money.

When minor children borrow from their parents to pay for their basic needs, there is no genuine debt. A bad debt cannot be deducted for such a loan.

Loan guarantees. If you guarantee a debt that becomes worthless, you cannot take a bad debt deduction for it unless you can show that your reason for making the guarantee was to protect your investment, or you entered the guarantee transaction with a profit motive. If you make the guarantee as a favor to friends and do not receive any consideration in return, it is considered a gift and you may not take a deduction.

Example 1. Henry Lloyd, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he entered into the guarantee to protect his investment in the corporation, Henry is able to take a nonbusiness bad debt deduction.

Example 2. Milt and John are co-workers. Milt, as a favor to John, guarantees a note at their local credit union. John does not pay the note and declares bankruptcy. Milt pays off the note. However, since he did not enter into the guarantee agreement to protect an investment, Milt may not take a bad debt deduction.

Deductible in year paid. Unless you have rights against the borrower, discussed next, a payment you make on a loan you guaranteed is deductible in the year you make the payment.

Right of subrogation (rights against a borrower). When you make payment on a loan that you guaranteed, you may have the right to take the place of the lender (the right of subrogation). The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become totally worthless.

Debts owed by political parties. You may not take a nonbusiness bad debt deduction for any worthless debt owed to you by a political party or other organization that accepts contributions or spends money to influence elections.

Mechanics' and suppliers' liens. Workers and material suppliers may file liens against property because of debts owed by a builder or contractor. If you pay off such a lien to avoid foreclosure and loss of your property, you are entitled to repayment from the builder or contractor. If the debt is uncollectible, you may take a bad debt deduction.

Insolvency of contractor. You can take a bad debt deduction for the amount you deposit with a contractor if the contractor becomes insolvent and you are unable to recover your deposit. If the deposit is for work unrelated to your trade or business, it is a nonbusiness bad debt deduction.

Secondary liability on home mortgage. If the purchaser of your home assumes your mortgage, you may remain secondarily liable for repayment of the mortgage loan. If the purchaser defaults on the loan, you may have to make up the difference if the house is then sold for less than the amount outstanding on the mortgage. You can take a bad debt deduction for the amount you pay to satisfy the mortgage, if you cannot collect it from the purchaser.

Worthless securities. If you own securities and they become totally worthless, you may take a deduction for a loss, but not for a bad debt. See *Worthless securities*, discussed earlier under *Investment Property*.

Reporting bad debts. Nonbusiness bad debts are deducted as short-term capital losses on Schedule D (Form 1040).

In Part I, line 2d of Schedule D (Form 1040), enter the name of the debtor and "schedule attached" in column (a), and the amount of the bad debt in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

1) A description of the debt, including the amount, and the date it became due,
2) The name of the debtor, and any business or family relationship between you and the debtor,
3) The efforts you made to collect the debt, and
4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Recovery of a bad debt. If you deducted a bad debt and in a later tax year you recover (collect) all or part of it, you may have to include the amount you recover in your gross income. However, you may exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year deducted.

Short Sales

A short sale occurs when you borrow property to deliver to a buyer and, at a later date, either buy substantially identical property and deliver it to the lender or make delivery out of such property that you held at the time of the sale. You usually determine your holding period on a short sale by the amount of time you actually hold the property eventually delivered to the lender to close the short sale. You will have a capital gain or loss if the property used to close the short sale is a capital asset.

Example. Even though you do not own any stock of the Ace Corporation, you contract to sell 100 shares of it which you borrow from your broker. After 13 months, when the price of the stock has fallen, you buy 100 shares of Ace Corporation stock and immediately deliver them to your broker to close out the short sale. Your gain is a short-term capital gain because your holding period of the delivered property is less than one day.

Special rules. The treatment of gains or losses, as discussed next, does not apply to any part of the property sold short that exceeds the amount of the substantially identical property. Property, for purposes of these rules, includes only stocks, securities, and commodity futures that are capital assets. Generally, it does not include straddles (see *Straddles*, later under *Section 1256 Contracts Marked to Market*).

The application of the treatment rules depends on how long you held the substantially identical property on the date of the short sale. It does not matter how long you held the property used to close the short sale.

Rules for treatment of gains. If you held property substantially identical to the property sold short for one year or less on the date of the short sale, or if you acquire property substantially identical to the property sold short after the short sale and on or before the date of closing the short sale, then:

Rule 1. Your gain, if any, when you close the short sale is a short-term capital gain, and

Rule 2. The holding period of the substantially identical property begins on the date of the closing of the short sale or on the date of the sale of this property, whichever comes first.

Example. On May 4, 1989, you bought 100 shares of Able Corporation stock for $1,000. On October 3, 1989, you sold short 100 shares of similar Able stock for $1,600. On November 3, 1989, you bought 100 more shares of Able stock for $1,800 which you used to close the short sale. On this short sale you realized a $200 short-term capital loss.

On June 5, 1990, you sold for $1,800 the stock you originally bought on May 4, 1989. Although you have actually held this stock for more than one year, because of rule (2) your holding period began on November 3, 1989, the date on which the short sale closed. The $800 gain realized on the sale is, therefore, a short-term capital gain.

Treatment of losses. If, on the date of a short sale of a capital asset, you held substantially identical property for more than one year, any loss you realize on the short sale is a long-term capital loss, even if you held the property used to close the sale for one year or less. Losses on short sales of certain stock or securities closed after July 18, 1984, are also subject to wash sale treatment. For information about these losses, see *Wash Sales*, later.

Mixed straddles. Under certain elections, you may avoid the treatment of long-term losses under the short sale rules for positions that are part of a mixed straddle. See *Other elections* under *Straddles Involving Interests in Personal Property* for more information about these elections.

Short sale expenses. If you borrow stock to make a short sale, you may have to remit to the lender payments in lieu of the dividends distributed while you maintain your short position. You may deduct these payments only if you hold the short sale open at least 46 days (more than 1 year in the case of an extraordinary dividend as defined below), and you itemize your deductions.

You deduct these expenses as investment interest on Schedule A (Form 1040). As previously discussed under *Interest Expenses*, your deduction for investment interest (including short sale expenses) for tax year 1990 is limited to your net investment income plus 10% of any excess investment interest over your net investment income, but not more than $1,000 ($500 if married and filing a separate return). The 2% limit that applies to certain other expenses of producing income does not apply to these short sale expenses.

If you close the short sale on or before the 45th day after the date of the short sale (1 year or less in the case of an extraordinary dividend), you may not deduct the payment in lieu of the dividend that you make to the lender. Instead, you must increase the basis of the stock used to close the short sale by that amount. (Increases to basis are discussed under *Adjusted Basis*, earlier.)

To determine how long a short sale is kept open, do not include any period during which you hold, have an option to buy, or are under a contractual obligation to buy substantially identical stock or securities. In addition, do not include any period during which you are considered to have diminished your risk of loss from the short sale by reason of holding one or more positions in substantially similar or related properties.

Exception. The deduction for amounts you pay in place of dividends will be disallowed only to the extent the payments exceed the amount that you receive as ordinary income from the lender of the stock for the use of collateral with the short sale. This exception does not apply to payments in place of extraordinary dividends.

Extraordinary dividends. If the amount of any dividend you receive on a share of preferred stock equals or exceeds 5% (10% in the case of other stock) of the amount realized on the short sale, the dividend you receive is an extraordinary dividend.

Reporting substitute payments. If any broker transferred your securities for use in a short sale, or similar transaction, and received certain substitute dividend payments in your behalf while the short sale was open, that broker must furnish you with **Form 1099–MISC** or a similar statement, reporting the amount of such payments. Form 1099–MISC must be used for those substitute payments totaling $10 or more that are known on the payment's record date to be in lieu of an exempt-interest dividend, a capital gain dividend, a return of capital distribution, or a dividend subject to a foreign tax credit, as well as for a payment in lieu of tax-exempt interest. Do not treat these substitute payments as dividends or interest. Instead, report the substitute payments shown on Form 1099–MISC as "Other income" on line 22 of Form 1040.

Substitute payment. A substitute payment means a payment in lieu of:

1) Tax-exempt interest (including OID) that has accrued while the short sale was open, and
2) A dividend, if the ex-dividend date is after the transfer of stock for use in a short sale and before the closing of the short sale.

Wash Sales

You cannot deduct losses from wash sales or trades of stock or securities. However, the gain from these sales is taxable.

A wash sale occurs when you sell stock or securities at a loss and within 30 days before or after the sale you buy or acquire in a fully taxable trade, or acquire a contract or option to buy, substantially identical stock or securities. If you sell stock and your spouse or a corporation you control buys substantially identical stock, you also have a wash sale. You add the disallowed loss to the basis of the new stock or security.

Stock or securities. Under the wash sale rules, stock or securities include contracts or options to acquire or sell stock or securities. They do not include commodity futures contracts and foreign currencies. See *Coordination of loss deferral rules and wash sale rules*, later under *Straddles Involving Interests in Personal Property* for information about the tax treatment of losses on the disposition of positions in a straddle.

Substantially identical. In determining whether stock or securities are substantially identical, you must consider all the facts and circumstances in your particular case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical, for example, in a reorganization, where the facts and circumstances may be such that the stocks and securities of the predecessor and successor corporations are substantially identical.

Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical. For example, preferred stock is substantially identical to the common stock if the preferred stock:

1) Is convertible into common stock,
2) Has the same voting rights as the common stock,
3) Is subject to the same dividend restrictions,
4) Trades at prices that do not vary significantly from the conversion ratio, and
5) Is unrestricted as to convertibility.

Example 1. You buy 100 shares of X stock for $1,000. You sell these shares for $750 and within 30 days from the sale you acquire 100 shares of the same stock for $800. You may not deduct your loss of $250 on the sale. However, you add the disallowed loss ($250) to the cost of the new stock ($800) to obtain your basis of the new stock which is $1,050.

Example 2. You are an employee of a corporation which has an incentive compensation plan. Under this plan, you are given 10 shares of the corporation's stock as a bonus award. You include the fair market value of the stock in your gross income as additional compensation. You later sell these shares at a loss. If you receive another bonus award of substantially identical stock within 30 days of the sale, you may not deduct your loss on the sale.

Wash sale rules apply to losses on certain short sales. The wash sale rules apply to a loss realized on the closing of a short sale if you sell, or enter into another short sale of, substantially identical stock or securities within a period beginning 30 days before the date of such closing and ending 30 days after such date.

If the number of shares of substantially identical stock or securities you buy within 30 days before or after the sale is less than the number of shares of stock or securities you sold, you must determine the particular shares of stock or securities to which the wash sale rules apply. You do this by matching the shares of stock or other securities sold with an equal number, up to the total, of the identical shares or securities bought. Match the shares in the same order that you acquired them. The shares or securities so matched are subject to the wash sale rules.

Example. You bought 100 shares of M stock on September 19, 1989, for $5,000. On December 19, 1989, you bought 50 shares of substantially identical stock for $2,750. On December 26, 1989, you bought 25 shares of substantially identical stock for $1,125. On January 5, 1990, you sold for $4,000 the 100 shares you bought in September. You have a $1,000 loss on the sale. However, because you bought 75 shares of substantially identical stock within 30 days of the sale, you cannot deduct the loss ($750) on 75 shares. You can deduct the loss ($250) on the other 25 shares.

Loss from a wash sale of one block of stock or securities may not be used to reduce any gains on identical blocks sold the same day.

Example. During 1982, you bought 100 shares of X stock on each of three occasions. You paid $158 a share for the first block of 100 shares, $100 a share for the second block, and $95 a share for the third block. On December 21, 1990, you sold 300 shares of X stock for $125 a share. On January 8, 1991, you bought 250 shares of identical X stock. You cannot deduct the loss of $33 a share on the first block because within 30 days after the date of sale you bought 250 identical shares of X stock. In addition, you cannot reduce the gain realized on the sale of the second and third blocks of stock by this loss.

For purposes of the wash sale rules, a short sale is considered complete on the date the short sale is entered into, if on that date:

1) You own, or by that date you enter into a contract or option to acquire, stock or securities identical to those sold short, and
2) You later deliver the stock or securities to close the short sale.

Otherwise, a short sale is not considered complete until the property is delivered to close the sale.

Example. On June 2, you buy 100 shares of stock for $1,000. You sell short 100 shares of the stock for $750 on October 6. On October 7, you buy 100 shares of the same stock for $750. You close the short sale on November 17 by delivering the shares bought on June 2. You may not deduct the $250 loss ($1,000 − $750) because the date of entering into the short sale (October 6) is considered the date of sale for wash sale purposes and you bought substantially identical stock within 30 days from the date of the sale.

Residual interests in a REMIC. The wash sale rules generally will apply to the sale of your residual interest in a REMIC if, during the period beginning 6 months before the sale of the interest and ending 6 months after such sale, you acquire any residual interest in any REMIC or any interest in a taxable mortgage pool that is comparable to a residual interest. REMICs are discussed earlier under *Real Estate Mortgage Investment Conduits (REMICs) and Other Collateralized Debt Obligations (CDOs).*

Dealer. The wash sale rules do not apply to a dealer in stock or securities if the loss is from a transaction made in the ordinary course of business.

Nondealers. For sales of stock or securities, the wash sale rules apply to all nondealers.

Basis adjustment. If your loss was disallowed because of the wash sale rules, your basis of the substantially identical stock or securities purchased is the basis of the stock sold, plus the amount that the price at which the new stock was acquired is more than the price at which the old stock was sold. If the price at which the old stock was sold is more than the price of the new stock, subtract the excess from the basis of the stock sold to determine your basis in the new stock.

Commodity Futures

A ***commodity future*** is a contract for the sale of some fixed amount of a commodity at a future date for a fixed price. The contracts are treated as either:

Hedges to insure against unfavorable price changes in a commodity bought or sold in the course of business, or

Capital investments.

Gains and losses on hedging contracts for a commodity purchased in the ordinary course of business to insure the price, or an adequate supply, of the commodity for use in the business are treated as ordinary business gains and losses. Hedging does not include any transaction entered into by or for a syndicate, as described later under *Hedging transactions.*

Section 1256 Contracts Marked to Market

A ***section 1256 contract*** is any:

Regulated futures contract,

Foreign currency contract,

Nonequity option, or

Dealer equity option.

Marked to market means that each section 1256 contract you hold at the close of the tax year will be treated as if you sold it for fair market value on the last business day of the tax year. See also *Determining gain or loss,* later.

A regulated futures contract is a contract that:

1) Provides that amounts that must be deposited to, or may be withdrawn from, your margin account depend on daily market conditions (a system of marking to market), and
2) Is traded on, or subject to, the rules of a ***qualified board or exchange,*** such as a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or any board of trade or exchange approved by the Secretary of the Treasury. By definition, a qualified board or exchange also includes a national securities exchange registered with the Securities and Exchange Commission. However, a regulated futures contract normally is not subject to the rules of, or traded in, a national securities exchange.

A foreign currency contract is a contract that:

1) Requires settlement depending on the value, or delivery, of a foreign currency that has positions traded through regulated futures contracts,
2) Is traded in the interbank market, and
3) Is entered into at arm's length at a price determined by reference to the price in the interbank market.

Bank forward contracts with maturity dates that are longer than the maturities ordinarily available for regulated futures contracts are considered to meet the definition of a foreign currency contract if the above three conditions are satisfied.

Special rules apply to certain foreign currency transactions. These transactions may result in ordinary gain or loss treatment. Internal Revenue Code Section 988 transaction rules apply to transactions entered into by an individual only to the extent that there are trade or business expenses or expenses for the production of income.

Nonequity and dealer equity options are defined later in this publication under *Options.*

Determining gain or loss (marked to market). A section 1256 contract that you acquire and that remains open at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the tax year.

60/40 rule. Under the marked-to-market system, 60% of the gain or loss that you would have had on a sale on the last business day of the tax year will be treated as a long-term capital gain or loss, and 40% will be treated as a short-term capital gain or loss. This is true regardless of the actual character and holding period of the property. When you later dispose of your section 1256 contracts, any gain or loss you have will be increased or decreased by the gain or loss that you had previously recognized. You may also elect to carry back losses from section 1256 contracts to offset prior gains from such contracts. See *Loss carryback election,* later in this discussion.

Terminations and transfers. The same rules for determining gain or loss also apply if your obligation or rights to section 1256 contracts are terminated or transferred during the tax year. In this case, use the fair market value of each section 1256 contract at the time of termination or transfer to determine the gain or loss. Terminations or transfers may result from any offsetting, delivery, exercise, assignment, or lapse of your obligation or rights to section 1256 contracts.

Example. On June 22, 1989, you purchased a regulated futures contract for $50,000. On December 29, 1989 (the last business day of your tax year), the fair market value of the regulated futures contract was $57,000. You have a $7,000 gain recognized on your 1989 tax return treated as 60% long-term and 40% short-term capital gain.

On February 2, 1990, you sold the regulated futures contract purchased on June 22, 1989, for $56,000. You have a $1,000 loss recognized on your 1990 tax return treated as 60% long-term and 40% short-term capital loss.

Loss carryback election. An individual or partnership having a net section 1256 contracts loss (defined below) for 1990 can elect to carry such loss back 3 years, instead of figuring a net capital loss and any applicable amount of loss carryover. The loss amount which may be carried back under this election, however, cannot be more than the net section 1256 contracts gain (defined below) in the year to which the loss is carried. In addition, the amount of loss carried back to an earlier tax year cannot increase or produce a net operating loss for such year.

The loss is carried to the earliest year first and any remaining loss amount can then be carried to each of the next two tax years. Treat 60% of the carryback amount as a long-term capital loss and 40% as a short-term capital loss from section 1256 contracts. See the discussion under *How to report,* later in this section, for information about reporting this election on your return.

A ***net section 1256 contracts loss*** is the lesser of:

1) The net capital loss for your tax year determined by taking into account only the gains and losses from section 1256 contracts, or
2) The sum of the amounts that would be allowable as a net capital loss carryover to the next tax year without applying the carryover limitations, described later.

A ***net section 1256 contracts gain*** is the lesser of:

1) The capital gain net income for the tax year determined by taking into account only gains and losses from section 1256 contracts, or
2) The capital gain net income for the tax year.

Figure your section 1256 contracts gain for any tax year that occurs before a loss year without regard for the net section 1256 contracts loss for such loss year or any later tax year.

Carryover limitations. If only a portion of the net section 1256 contracts loss is absorbed by carrying the loss back, then an amount equal to the unabsorbed portion can be carried forward. The character of the amount carried forward is determined by:

1) Deeming 60% of the carryback to be a long-term capital gain and 40% to be a short-term capital gain, and
2) Offsetting the net 1256 contracts loss with these deemed gains.

Reduce the carryover amount by any amount used as a carryback. Any net capital loss carryover that is derived from section 1256 contracts continues to be treated as a loss from section 1256 contracts in such later tax year.

Special rules. If your section 1256 contracts were at any time actively-traded personal property ***identified*** by you as being part of a ***hedging transaction,*** described later, you cannot treat the property as a capital asset in determining any gain from its sale or exchange. If the sale or exchange of your property requires ordinary income or loss treatment, you cannot use the 60/40 capital gain or loss rule.

The capital gain or loss treatment rules, described earlier in this discussion, also apply to ***traders in section 1256 contracts,*** unless such a contract is held for hedging purposes and any resulting loss would be an ordinary loss. The fact that an individual is actively engaged in dealing or trading in section 1256 contracts is not a consideration in determining which gain or loss treatment to use.

How to report. If you disposed of regulated futures or foreign currency contracts in 1990 (or had unrealized profit or loss on such contracts that were open at the end of 1989 or 1990), you should receive Form 1099–B, or an equivalent statement, from your broker.

Form 6781. Use Part I of Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles,* to report the amounts shown in Box 9 of Form 1099–B, or on the equivalent statement. Also use Form 6781 to figure your gains and losses from all section 1256 contracts that are open at the end of the year or that were closed out during the year, before entering these amounts on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

If the Form 1099–B you receive includes a straddle or hedging transaction, defined later, it may be necessary to show certain adjustments on Form 6781. Follow the Form 6781 instructions for completing Part I.

Loss carryback election. To carry your loss back under the election procedures described earlier, file an amended Form 6781 for the applicable year, together with Form 1040X, or appropriate amended return. Follow the instructions for completing Form 6781 to make this election.

Hedging transactions. The marked-to-market 60/40 rules, described earlier, do not apply to certain hedging transactions. A transaction is ***excluded*** from the 60/40 rules if three conditions are met:

1) You entered into the transaction in the normal course of your trade or business primarily to reduce the risk of:
   a) Price changes or currency fluctuations on property you hold (or are about to hold), or
   b) Interest rate or price changes, or currency fluctuations on your current or future borrowings, or on your current or future obligations;
2) You treat the gain or loss on such transactions as ordinary income or loss; and
3) You clearly identified the transaction as being a hedging transaction before the close of the day on which you entered into it, or such earlier time as defined by regulations.

This hedging transaction exclusion, however, does not apply to transactions entered into by or for any ***syndicate,*** defined as a partnership, S corporation, or other entity (other than a regular corporation) that allocates more than 35% of its losses to ***limited partners*** or ***limited entrepreneurs.*** A limited entrepreneur is a person who has an interest in an enterprise (but not as a limited partner) and who does not actively participate in its management. However, you are not considered a limited partner or entrepreneur if you actively participate (or did so for at least 5 full years) in the management of an entity in which you, or your spouse, children (including your legally adopted child), grandchildren, and parents hold an interest.

Hedging loss limitation. A "hedging loss" is the amount by which the allowable deductions in a tax year that resulted from a hedging transaction (determined without regard to the limitation, described next) exceed the income which you received or accrued during the tax year from such transaction.

If you are a limited partner or entrepreneur in a partnership, S corporation, or other entity (other than a regular corporation) that allocates 35% or less of its losses to the limited partners or entrepreneurs, the amount of a hedging loss you may claim is limited. Any hedging loss that is allocated to you for the tax year is limited to your taxable income for that year from the trade or business in which the hedging transaction occurred. Ignore any hedging transaction items in determining such taxable income. Carry over any hedging loss that is disallowed because of the limitation to the first following tax year as a deduction attributable to a hedging transaction.

If the hedging transaction relates to property other than stock or securities, the limitation on hedging losses applies only if the limited partner or entrepreneur is an individual, or a corporation in which, at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned by five or fewer individuals.

The limitation on losses from hedging transactions does not apply to any hedging loss to the extent that such loss exceeds the aggregate unrecognized gains from hedging transactions, including gains from hedged property, at the end of the tax year that are attributable to the trade or business in which the hedging transaction occurred. The term "unrecognized gain" has the same meaning as defined later under *Straddles Involving Interests in Personal Property.*

Self-employment income. Gains and losses derived in the ordinary course of a commodity or option dealer's trading in section 1256 contracts and property related to such contracts are defined as earnings from self-employment. In addition, the rules relating to contributions to self-employment retirement plans apply. For more information, see Publication 535, *Business Expenses,* Publication 560, *Retirement Plans For the Self-Employed,* and Publication 590, *Individual Retirement Arrangements (IRAs).*

Non-regulated futures contracts. A non-regulated futures contract, such as a forward contract, is not subject to the marked-to-market 60/40 rules. Except for straddles, gains and losses on these contracts held as capital investments are generally treated in the same manner as other capital gains and losses.

Straddles. Special rules apply to the amount of loss you may deduct on the sale of one or more positions of a straddle. Generally, if you established a position, other than on section 1256 contracts, you may deduct a loss on the position only to the extent that the loss exceeds any unrecognized gain you have on offsetting positions that consist of one or more positions from which the loss arose. Unused losses may be carried forward to offset gains on straddle positions in the next tax year.

Additional rules apply to straddles in non-section 1256 contracts and to mixed straddles (a straddle where one position is a section 1256 contract and the offsetting position is a non-section 1256 contract). These rules will be covered later in this publication under *Straddles Involving Interests in Personal Property.*

Options

Section 1256 contracts include nonequity options and dealer equity options. The taxation of these contracts is the same as for other section 1256 contracts. Both of these options are listed options. A ***listed option*** is any option which is traded on, or subject to the rules of, a qualified board or exchange (as discussed earlier in *A regulated futures contract* under *Section 1256 Contracts Marked to Market*). A listed option, however, does not include an option that is a right to acquire stock from the issuer.

Nonequity option means any listed option which is not an equity option. Nonequity options include debt options, commodity futures options, currency options, and broad-based stock index options, such as options on the High Technology Index, and the Institutional Index.

A dealer equity option is any listed option which, for an options dealer:

1) Is an equity option,
2) Is purchased or granted by such dealer in the normal course of that business activity, and
3) Is listed on the qualified board or exchange where that dealer is registered.

An equity option is any option:

1) To buy or sell stock, or
2) That is valued directly or indirectly by reference to any stock, group of stocks, or stock index.

Equity options include certain narrow-based stock indexes, but exclude options on broad-based stock indexes and options on stock index futures. A broad-based stock index is based upon the value of a group of diversified stocks or securities (such as the Standard & Poor's 500 index). Investors in equity options (other than dealers) remain subject to the general rules for the taxation of options, including the loss deferral rules to be covered later in this publication, under *Straddles Involving Interests in Personal Property.*

An equity option, however, does ***not*** include an option for any group of stocks or stock index, if:

1) The Commodities Futures Trading Commission has designated a contract market for a contract based on such group or index, and such designation is in effect, or
2) The Secretary of the Treasury determines that such option meets the legal requirements for such a designation.

The 60/40 rule does not apply to dealer equity options that result in gain or loss allocable to ***limited partners*** or ***limited entrepreneurs.*** Instead, treat all such gains or losses as short-term capital gains or losses respectively, under the marked-to-market system.

An ***options dealer*** is any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

Example. On December 11, 1990, a dealer in equity options purchased 10 XYZ options in his dealer-maker account for a cost (premium) of $1,200 per option. Each option consisted of 100 shares. The total cost was $12,000. On December 31, 1990, the end of the dealer's tax year, the fair market value per option was $1,300, for a total fair market value of $13,000. The dealer must recognize a gain of $1,000 on his 1990 tax return due to the marked-to-market rules under Section 1256. The gain is treated as 60% long-term and 40% short-term capital gain and is reported on Form 6781. If the option expires in 1991, without being exercised or closed out, the dealer has a loss of $13,000 that is reported on his 1991 return as a 60% long-term and 40% short-term capital loss. The loss is the total cost of the option, $12,000, plus the gain, $1,000, previously reported on the 1990 return due to the marked-to-market rules.

Non-dealer equity options. Gain or loss from the sale or trade of a listed equity option traded by a non-dealer, or traded by dealers as part of their investment activity instead of dealer activity, is a gain or loss from the sale or trade of a capital asset.

Gain or loss from the sale or trade of a non-listed option to buy or sell property that is not a capital asset in your hands, or would not be if you acquired it, is ordinary gain or loss, such as certain options to purchase real estate in the ordinary course of a trade or business. Under certain circumstances, this may be treated as a capital gain or loss.

Example 1. You purchased an option to buy 100 shares of XYZ Company stock. The stock increases in value and you sell the option for more than you paid for it. Your gain is capital gain because the stock underlying the option would have been a capital asset in your hands.

Example 2. Assume the same facts as in Example 1, except that the stock decreases in value and you sell the option for less than you paid for it. Your loss is a capital loss.

If you do not exercise an option to buy or sell, and you have a loss, you are considered to have sold or traded the option on the date that it expired. Your loss is a capital loss if the option is a capital asset to you. The loss is an ordinary loss if the option is not a capital asset to you.

The capital asset treatment does not apply:

1) To a gain from the sale or trade of a non-listed option, if the gain from a sale of the property underlying the option would be ordinary income, or
2) To a dealer in non-listed options, if the option is part of inventory.

Your holding period for property that you acquired under an option to buy begins on the day after you acquired the property, not the day after you acquired the option.

If you grant (write) an option, how you report your gain or loss depends on whether it was exercised.

If you grant (write) an option on stocks or securities and it is not exercised, the amount you receive, if you are not in the business of granting options, is a short-term capital gain.

Gain or loss from the closing or expiration of an option that is not a section 1256 contract, but that is a capital asset in your hands, is reported on Schedule D (Form 1040).

If a purchased option expired, enter the expiration date in column (c), and write "Expired" in column (d).

If an option granted (written) expired, enter the expiration date in column (b), and write "Expired" in column (e).

If the option is exercised, you add the option payment to other amounts you receive to figure the amount you realize on the sale of the property. Whether your gain or loss is capital or ordinary is determined by the type of property you sell.

Section 1256 contract options. Treat section 1256 contract options as options to buy or sell property. Gain or loss is recognized on the exercise of an option on a section 1256 contract. Section 1256 contracts are defined earlier under *Section 1256 Contracts Marked to Market.*

Cash settlement option. A cash settlement option is treated as an option to buy or sell property. A cash settlement option will be either an equity or nonequity option depending upon the underlying property.

A cash settlement option is any option that on exercise settles in, or could be settled in, cash or property other than the underlying property.

Calls and Puts

Calls and puts are options on securities and are covered by the rules just discussed for options. The following are specific applications of these rules to holders and writers of non-dealer equity listed options that are bought, sold, or "closed out" in transactions on the Chicago Board Options Exchange.

Calls and puts are issued by writers (grantors) to holders for cash premiums. They are ended by exercise, closing transaction, or lapse.

A ***call option*** is the right to buy from the writer of the option, at any time before a specified future date, a stated number of shares of stock at a specified price. Conversely, a ***put option*** is the right to sell to the writer, at any time before a specified future date, a stated number of shares at a specified price.

Holders of calls and puts. If you buy a call or a put, you may not deduct its cost. It is a capital expense.

If you sell the call or the put before you exercise it, the difference between its cost and the amount you receive for it is either a long-term or short-term capital gain or loss, depending on how long you held it.

If the option expires, its cost is either a long-term or short-term capital loss, depending on your holding period, which ends on the expiration date.

If you exercise a call, add its cost to the basis of the stock you bought. If you exercise a put, reduce your amount realized on the sale of the underlying stock by the cost of the put when figuring your gain or loss. The gain or loss is long-term or short-term depending on your holding period for the underlying stock.

Short sale. Your acquisition of a put option is generally treated as a short sale, and the exercise, sale, or expiration of the put is a closing of the short sale. If you have held the underlying stock for one year or less at the time you acquire the put, any gain on the exercise, sale, or expiration of the put is a short-term capital gain. The same is true if you acquire the underlying stock after you acquire the put but before its exercise, sale, or expiration. Your holding period for the underlying stock begins on the earliest of:

1) The date you dispose of the stock,
2) The date you exercise the put,
3) The date you sell the put, or
4) The date the put expires.

Writers of calls and puts. If you write (grant) a call or a put, do not include the amount you receive for writing it in your income at the time of receipt. Carry it in a deferred account until:

1) Your obligation expires,
2) You sell, in the case of a call, or buy, in the case of a put, the underlying stock when the option is exercised, or
3) You engage in a closing transaction.

If your obligation expires, the amount you receive on the expiration is short-term capital gain.

If a call you write is exercised and you sell the underlying stock, increase your amount realized on the sale of the stock by the amount you received for the call when figuring your gain or loss. The gain or loss is long-term or short-term depending on your holding period of the stock.

If a put you write is exercised and you buy the underlying stock, decrease your basis in the stock by the amount you received for the put. Your holding period for the stock begins on the date you buy it, rather than on the date you wrote the put.

If you enter into a closing transaction by paying an amount equal to the value of the call or put at the time of the payment, the difference between the amount you pay and the amount you received for the call or put is a short-term capital gain or loss.

Examples of non-dealer transactions.

1) ***Expiration.*** Ten XYZ call options were issued on April 10, 1990, for a total premium (cost) of $4,000. These equity options expired in December 1990, without being exercised. If you were a holder (purchaser) of the options, you would recognize a short-term capital loss of $4,000 on Schedule D of your 1990 return. If you were a writer of the options, you would recognize a short-term capital gain of $4,000 on Schedule D of your 1990 return.
2) ***Closing transaction.*** The facts are the same as in (1), except that on May 15, 1990, the options were sold for $6,000. If you sold the options you purchased for $4,000, you would recognize a short-term capital gain of $2,000 on Schedule D of your 1990 return. If you were the writer of the options and you paid an amount equal to the value of the call, you would recognize a short-term capital loss of $2,000 on Schedule D of your 1990 return.
3) ***Exercise.*** The options in (1) were exercised on May 29, 1990. There is no taxable gain or loss on the options to the purchaser or writer at the time of the exercise. (The purchaser adds the premium (cost) of the options to the basis of the stock bought through the exercise of the options. The writer adds the premium received from the options to the amount realized on the sale of stock through the exercise of the options.)
4) ***Section 1256 contracts.*** The facts are the same as in (1), except the options were nonequity options, subject to the rules for section 1256 contracts. If you were a purchaser of the options, you would recognize a short-term capital loss of $1,600, and a long-term capital loss of $2,400. If you were a writer of the options, you would recognize a short-term capital gain of $1,600, and a long-term capital gain of $2,400.

Straddles Involving Interests in Personal Property

Special rules, known as the ***loss deferral rules,*** apply to the amount of loss you can deduct on the sale of one or more positions of a straddle in other than section 1256 contracts. Generally, if you establish a position in a non-section 1256 contract, or in an equity option and you are not a dealer, you may deduct a loss on the position only to the extent that the loss exceeds any unrecognized gain you have on offsetting positions of one or more positions from which the loss arose. Unused losses are treated as sustained in the succeeding tax year subject to the above loss deferral limitations. These loss deferral rules apply to all non-section 1256 contracts and to non-dealer equity options.

Exceptions to straddle rules. The loss deferral and carryover rules on straddles involving an interest in personal property do not apply to any straddle which is an ***identified straddle*** at the close of the tax year. See *Identified straddle,* later, for more information.

These rules also do not apply to any ***hedging transactions,*** described previously under *Section 1256 Contracts Marked to Market.*

Definitions. To understand straddles and offsetting positions, you will need to know the following terms.

A ***straddle*** is any set of offsetting positions, except for certain straddles consisting of qualified covered call options and the optioned stock, discussed later.

A ***position*** is an interest in actively-traded personal property other than stock. (But see *Straddle rules for stock,* later in this discussion.) A position may be a forward or futures contract or an option.

An interest in a loan that is denominated in a ***foreign currency*** is treated as a position in that currency. For this purpose, foreign currency for which there is an active interbank market is considered to be actively traded personal property. See also *A foreign currency contract,* earlier under *Section 1256 Contracts Marked to Market.*

An ***offsetting position*** is a position that substantially reduces any risk of loss you may have from holding another position. However, if a position is part of an unidentified straddle, do not treat it as offsetting to a position that is part of an identified straddle, described later. See also the discussion below on *Presumed offsetting positions.*

An ***unrecognized gain*** is the amount of gain you would have if you sold a position on the last business day of the tax year at its fair market value, and the amount of gain realized, but not recognized, on a position as of the end of the tax year.

Presumed offsetting positions. If you establish two or more positions, an offsetting position will be presumed under any of the following conditions, unless otherwise rebutted.

1) The positions are established in the same personal property (or in a contract for such property) and one or more positions vary inversely with the value of one or more of the other positions.
2) The positions are in the same personal property, even if such property is in a substantially changed form, and the positions vary inversely, as described in the first condition.
3) The positions are in debt instruments with a similar maturity (or other debt instruments described in regulations), and the positions vary inversely, as described in the first condition.
4) The positions are sold or marketed as offsetting positions, whether or not such positions are named a straddle, spread, butterfly, or any similar name.
5) The aggregate margin requirement for such position is lower than the sum of the margin requirements for each position, if held separately.
6) There are such other factors, or satisfaction of certain tests, as regulations prescribe, to indicate offsetting positions, and the positions vary inversely, as described in the first condition.

Example. On July 3, 1990, you entered into a straddle in non-section 1256 contracts. On December 21, 1990, you closed one position of the straddle at a loss of $15,000. On December 31, 1990, the end of your tax year, there is an unrealized gain of $12,750 in the offsetting open position. On your 1990 return, you are limited to a loss of $2,250, which is the excess of the loss over the unrecognized gain of the open position. The unused loss of $12,750 is carried forward to the following year.

Related persons. To determine if two or more positions are offsetting, you will be treated as holding any position that your spouse holds during the same period. If you account for part or all of the gain or loss for a position held by a flowthrough entity, such as a partnership, trust, or other entity, you are also considered to hold that position.

Qualified covered call options and optioned stock. If all of the offsetting positions of a straddle consist of one or more qualified covered call options and the stock to be purchased from you under the options, and the straddle is not part of a larger straddle, the straddle is ***not subject*** to the loss deferral rules affecting straddles. But see the later discussions on certain exceptions that may apply.

A ***qualified covered call option*** is any option you grant to purchase stock you hold (or stock you acquire in connection with granting the option) but only if:

1) The option is traded on a national securities exchange or other market approved by the Secretary of the Treasury,
2) The option is granted more than 30 days before its expiration date,
3) The option is not a deep-in-the-money option,
4) The option is not granted by an options dealer in connection with his or her activity of dealing in options, and
5) Gain or loss on the option is not ordinary income or loss.

A ***deep-in-the-money*** option is an option with a strike price lower than the lowest qualified benchmark (LQB). The strike price is the price at which the option is to be exercised. The LQB is the highest available strike price that is less than the applicable stock price. However, the LQB for an option with a term of more than 90 days and a strike price that is more than $50 is the second highest available strike price that is less than the applicable stock price. The strike prices are listed in the financial section of many newspapers.

The ***applicable stock price*** for any stock for which an option has been granted is:

1) The closing price of the stock on the most recent day on which such stock was traded before the date on which the option was granted, or
2) The opening price of the stock on the day on which the option was granted, but only if such price is greater than 110% of the price determined in (1).

If the applicable stock price is $25 or less, the LQB will not be treated as being less than 85% of the applicable stock price. If the applicable stock price is $150 or less, the LQB will not be treated as being less than an amount that is $10 below the applicable stock price.

The loss deferral rules for straddles apply to certain qualified call options and the optioned stock if:

1) The qualified covered call options are closed or the stock is disposed of at a loss during any tax year,
2) Gain on disposition of the stock or gain on such options are includible in gross income in a later tax year, and
3) The stock or options were not held 30 days or more after the closing of the options or the disposition of such stock.

Example. An XYZ/September call option was granted on May 14, 1990. The closing market of one share of XYZ stock on May 11, 1990, was $130¼. The strike prices of all the XYZ/September options offered on May 14, 1990, were as follows: $110, 115, 120, 125, 130, and 135. The option was granted more than 90 days prior to expiration. The lowest qualified benchmark is the second highest strike price, that is less than the stock price. This amount is $125. On May 14, 1990, you held XYZ stock and you acquired an XYZ/September option granted for a strike price of $120. The call granted is a deep-in-the-money option because it is lower than the lowest qualified benchmark. The option granted is not a qualified covered call option and the loss deferral rules apply if the call or the stock was closed out at a loss during the year.

Capital loss on qualified covered call options. If you hold stock and you grant a covered call option to buy such stock with a strike (exercise) price less than the applicable stock price, treat any loss from the option as long-term capital loss if, at the time the loss was realized, gain on the sale or exchange of the stock would be treated as long-term capital gain. The holding period on the stock does not include any period during which you are the grantor of the option.

Interest expense and carrying charges relating to straddles. You cannot deduct interest and carrying charges that are allocable to any interest in personal property that is part of a straddle. However, this treatment does not apply if all the offsetting positions making up the straddle either consist of one or more qualified covered call options and the optioned stock, or consist of section 1256 contracts (and such straddle, in either case, is not part of a larger straddle), or if the straddle is a hedging transaction. The nondeductible interest and carrying charges are added to the basis of the straddle property.

To find the amount of interest and carrying charges that is not deductible and that must be added to the basis of the straddle property:

1) Add together —
    a) Interest on indebtedness incurred or continued to purchase or carry the personal property.
    b) All other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property.
2) Subtract the sum of the following from the amount in (1) —
    a) Interest (including OID) includible in gross income for the year with respect to the personal property.
    b) Any amount treated as ordinary income on the disposition of short-term government obligations, and any amount treated as ordinary income under the market discount and short-term bond discount provisions. See *Discount on Debt Instruments.*
    c) The dividends includible in gross income with respect to the personal property for the year.
    d) Any payment on a security loan (used in a short sale) that is includible in gross income with respect to the personal property.
3) The excess of the amount in (1) over the amount in (2) is not deductible. Add the result to the basis of your straddle property.

Interest includes any amount you pay or incur in connection with personal property used in a short sale. However, you must first apply the rules discussed earlier in *Short sale expenses* under *Short Sales.*

For market discount bonds and short-term obligations that are part of a straddle, you must first apply the rules discussed earlier under *Deferral of interest expense deduction for interest on a market discount bond* and *Deferral of interest deduction on short-term obligations* (both under *Interest Expenses*).

Identified straddle. Any straddle consisting of non-section 1256 contracts will be considered as an ***identified straddle*** if all of the following conditions exist:

1) You clearly identified the straddle on your records before the close of the day on which you acquired it, or such time as prescribed by future regulations,
2) All of the original positions that you identify were acquired on the same day,
3) All of the positions included in item (2), above, were either disposed of on the same day during the tax year or none of the positions were disposed of by the end of the tax year, and
4) The straddle is not part of a larger straddle.

The loss deferral and carryover rules on straddles involving an interest in non-section 1256 contracts in personal property do not apply to any straddle that is an identified straddle at the close of the tax year. Defer treatment of any loss on an identified straddle until the day you dispose of all the positions making up the straddle.

Do not offset any position in an identified straddle with a position which is not part of the identified straddle.

Section 1256 contracts. If at least one (but not all) of the positions of an unidentified straddle is a section 1256 contract, the gain and loss rules for straddles involving interests in personal property will apply to the section 1256 contract and to any other position making up the straddle. But also see *Mixed straddle election,* later.

If all of the offsetting positions of an identified straddle consist of section 1256 contracts, the loss deferral rules will not apply to such section 1256 contracts.

Straddle rules for stock. Generally, stock, but not any stock option, is excluded from the definition of personal property when applying the straddle rules. However, the definition of personal property has been extended to stock in the following two situations.

1) Any stock that is part of a straddle in which at least one of the offsetting positions is an option to buy or sell the stock or substantially identical stock or securities, or a position with respect to substantially similar or related property (other than stock), and
2) Any stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

For stock covered under these straddle rules, the definitions and rules explained earlier for presumed offsetting positions, qualified covered call options, and the determinants for positions held by related persons also apply, as if such stock were personal property.

How to report gains and losses (Form 6781). Report each position (whether or not it is part of a straddle) on which you have unrecognized gain at the end of the tax year and the amount of such unrecognized gain on Part III of Form 6781. Use Part II of Form 6781 to figure your gains and losses on straddles before entering these amounts on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

Accuracy-related penalties. For tax returns due after 1989, a 20% accuracy-related penalty may be charged for underpayments of tax due to negligence or disregard of rules or regulations or substantial understatement of tax. For more information on the penalty and any applicable interest, see *Penalties* under *Tax Shelters,* earlier.

Coordination of loss deferral rules and wash sale rules. Rules similar to the wash sale rules apply to any loss sustained on the disposition of direct positions in stock. If a loss from the disposition of a position that was part of a straddle is otherwise sustained, the loss treatment for straddles (discussed in this section) will be applied. However, you must first consider the loss treatment of any disposition of shares of stock or securities that make up the positions of a straddle.

Rule 1. Any loss you sustain on the disposition of shares of stock or securities that make up the positions of a straddle will not be taken into account if, within a period beginning 30 days before the date of such disposition and ending 30 days after that date, you acquired substantially identical stock or securities. Instead, such a loss will be carried over to the following tax year, subject to any further application of Rule 1 in that year. This rule will also apply if you entered into a contract or option to acquire such stock or securities within the time period described above. See *Loss carryover,* later, for more information about how to treat such losses in the following tax year. If you are a dealer in stock or securities, however, this loss treatment will not apply to any losses you sustained in the ordinary course of your business.

Example. Assume you are not a dealer in stock or securities. On December 3, 1990, you bought stock in XX Corporation (XX stock) and an offsetting put option. On December 14, 1990, there was $20 of unrealized gain in the put option and you sold the XX stock at a $20 loss. By December 18, 1990, the value of the put option has declined, eliminating all unrealized gain in the position. On December 18, 1990, you bought a second XX stock position that is substantially identical to the XX stock you sold on December 14, 1990. At the end of the year there is no unrecognized gain in the put option or in the XX stock. Under these circumstances, the $20 loss will be disallowed for 1990 under Rule 1 because, within a period beginning 30 days before December 14, 1990, and ending 30 days after that date, you bought stock substantially identical to the XX stock you sold.

Note: Rule 1 applies only if stocks or securities make up a position that is part of the straddle. If a position in the straddle does not include stock or securities, use Rule 2.

Rule 2. Any loss you sustain on the disposition of less than all of the positions of a straddle (loss position) will not be taken into account to the extent that any unrecognized gain at the close of the tax year in one or more of the following positions exceeds the amount of any loss disallowed under Rule 1:

1) Successor positions,
2) Offsetting positions to the loss position, or
3) Offsetting positions to any successor position.

Example. Assume the same facts as in the example under Rule 1 above, except that on December 31, 1991, you sell the XX stock at a $20 loss and there is $40 of unrecognized gain in the put option. Under these circumstances, you will not recognize in 1991, either the $20 disallowed in 1990 or the $20 loss you incurred for the December 31, 1991, sale of XX stock. Rule 1 does not apply to disallow the losses in 1991, since the substantially identical XX stock was sold during the year (and no substantially identical stock or securities were bought within the 61–day period). However, Rule 2 does apply to disallow for 1991 the $40 of losses you incurred for the sales of the positions in the straddle because there is $40 of unrecognized gain in the put option, an offsetting position to the loss position.

Loss carryover. If you have an unused loss that resulted from applying Rule 1 and Rule 2, you must carry it over to the next tax year and apply Rule 1 and Rule 2 to that carryover loss. For example, a loss disallowed in 1990, under Rule 1, will not be allowed in 1991, unless the substantially identical stock or securities (which caused the loss to be disallowed in 1990) are disposed of during 1991. In addition, the loss carryover will not be allowed in 1991, if Rule 1 and Rule 2 disallow it.

If the sale of a loss position would have resulted in a capital loss, you treat the carryover loss as a capital loss on the date it is allowed, even if you treated the gain or loss on any successor positions as ordinary income or loss. Likewise, if the sale of a loss position (in the case of section 1256 contracts) would have resulted in a 60% long-term capital loss and a 40% short-term capital loss, you treat the carryover loss under the 60/40 rule, even if you treated any gain or loss on any successor positions as 100% long-term or short-term capital gain or loss.

A ***successor position*** refers to a position that is or was at any time offsetting to a second position, if both of the following conditions are evident:

1) The second position was offsetting to any loss position that was sold; and
2) The successor position is entered into during a period beginning 30 days before, and ending 30 days after, the sale of the loss position, described in (1).

Exceptions. The rules for coordinating straddle losses and wash sales do not apply to the following loss situations:

1) Hedging transactions that include the sale of one or more positions;
2) Mixed straddle accounts that include the sale of a loss position (see the discussion later in this publication on the mixed straddle account election); and
3) A sale of a position that is part of a straddle consisting only of section 1256 contracts.

For more information about identified straddles, offsetting positions, unrecognized gain, and determining gain or loss on the sale of one or more straddle positions, see the discussions earlier in this section of the publication. Hedging transactions are described earlier under *Section 1256 Contracts Marked to Market.*

Basic loss deferral rule. The following examples illustrate the basic loss deferral rule without a successor position. See *Rule 2* earlier.

Example 1. On December 3, 1990, you entered into offsetting long and short positions. On December 11, 1990, you disposed of the short position at an $11 loss. At year end, you have an unrecognized gain of $5 in the offsetting long position. Only $6 of the loss is deductible in 1990. You can carry forward the remaining $5 into 1991.

Example 2. Assume the same facts as in Example 1, except that at year end, you have $11 of unrecognized gain in the offsetting long position. Under these circumstances, the entire $11 loss will be disallowed for 1990, because there is $11 of unrecognized gain at year end in the offsetting long position.

Successor positions. The following examples illustrate successor positions. See *Rule 2,* earlier.

Example 1. On November 2, 1990, you entered into offsetting long and short positions in non-section 1256 contracts. On November 9, 1990, you disposed of the long position at a $10 loss. On November 13, 1990, you entered into a new long position (successor position) that is offsetting with respect to the retained short position, but that is not substantially identical to the long position disposed of on November 9, 1990. You held both positions through year end, at which time there was $10 of unrecognized gain in the successor long position and no unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1990, because there is an unrecognized gain in the successor long position.

Example 2. Assume the same facts as in Example 1, except that at year end, you have $4 of unrecognized gain in the successor long position and $6 of unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 1990, because there is a total of $10 of unrecognized gain in both the successor long position and offsetting short position.

Example 3. Assume the same facts as in Example 1, except that at year end, you have $8 of unrecognized gain in the successor long position and $8 of unrecognized loss in the offsetting short position. Under these circumstances, $8 of the total $10 realized loss will be disallowed for 1990, because there is $8 of unrecognized gain in the successor long position.

Holding period rules. To determine if long-term or short-term treatment applies, the holding period for any position that is part of a straddle (consisting only of non-section 1256 contracts) begins no earlier than the date on which the straddle ceases. If the position is held for less than the long-term holding period prior to establishing the straddle, the entire holding period is eliminated and begins again once the straddle ends. If you have already held a position for the long-term holding period prior to establishing the straddle, then any gain or loss realized as a result would be long term. See *Exceptions,* later.

Example. On March 3, 1989, you acquired gold. On January 3, 1990, you entered into an offsetting short gold forward contract (nonregulated futures contract). On April 3, 1990, you disposed of the short gold forward contract at no gain or loss. On April 10, 1990, you sold the gold at a gain. Since the gold had not been held for a long-term period before the offsetting short position was entered into, the holding period for the gold begins no earlier than the time the straddle is terminated. Thus, the holding period of the gold purchased on March 3, 1989, and sold on April 10, 1990, begins on April 3, 1990, the date the straddle was terminated. Consequently, gain recognized with respect to the gold will be treated as short-term capital gain.

Loss treatment. Treat the loss on the sale of one or more positions (the loss position) of a straddle as a long-term capital loss, if:

1) You held (directly or indirectly) one or more offsetting positions to the loss position on the date you entered into the loss position; and
2) You would have treated all gain or loss on one or more of the straddle positions as long-term capital gain or loss if you had sold such positions on the day you entered into the loss position.

Exceptions. The treatment for holding periods and losses for straddle positions does not apply to positions that:

1) Constitute part of a hedging transaction;
2) Are included in a straddle consisting only of section 1256 contracts; or
3) Are included in a mixed straddle account. (See *Other elections,* later).

Mixed straddles. Special rules apply to a loss position that is part of a mixed straddle and that is a non-section 1256 position. A ***mixed straddle*** for this purpose is a straddle that is not part of a larger straddle and for which:

1) All positions are held as capital assets;
2) At least one (but not all) of the positions is a section 1256 contract; and
3) The mixed straddle election governing section 1256 contracts has not been made. (This election is discussed later.)

Treat such a loss position as 60% long-term capital loss and 40% short-term capital loss, if all of the following conditions apply:

1) Gain or loss from the sale of one or more of the straddle positions that are section 1256

contracts would be considered gain or loss from the sale or exchange of a capital asset;

2) The sale of no position in the straddle, other than a section 1256 contract, would result in a long-term capital gain or loss; and
3) You have not made a straddle-by-straddle identification election or mixed straddle account election. See *Other elections,* later.

Example. On March 2, 1990, you entered into a long gold forward contract. On July 17, 1990, you entered into an offsetting short gold regulated futures contract. You did not make an election to offset gains and losses from positions in a mixed straddle. On August 10, 1990, you disposed of the long forward contract at a loss. Since the gold forward contract was part of a mixed straddle, and the disposition of this non-section 1256 position in the straddle gives rise to a loss, the loss recognized on the termination of the gold forward contract will be treated as a 60% long-term and 40% short-term capital loss.

Mixed straddle election (Election A). You can elect not to have the marked-to-market rules for determining gain and loss, discussed earlier under *Section 1256 Contracts Marked to Market,* apply to all section 1256 contracts that are part of a mixed straddle. Instead, the gain and loss rules for straddles will apply to these contracts. A ***mixed straddle*** is any straddle, at least one (but not all) of the positions of which is a section 1256 contract.

Under the election, each position forming part of the straddle must be clearly identified as being part of such straddle on the day the first section 1256 contract forming part of the straddle is acquired. If you make this election, it will apply for all later years as well. It cannot be revoked without the consent of the IRS. If you made this election, check Box A of Form 6781 and report the section 1256 component in Part II of Form 6781. However, if you make this election for an option on a section 1256 contract, the gain or loss treatment discussed earlier under *Options* will apply, subject to the gain and loss rules for straddles. If you choose this election, you avoid the 60% long-term capital loss treatment required for a non-section 1256 loss position that is part of a mixed straddle, described earlier.

Other elections. You may avoid the 60% long-term capital loss treatment required for a non-section 1256 loss position that is part of a mixed straddle, described earlier, if you choose either of the two following elections to offset gains and losses for such positions:

1) ***Election B.*** Make a separate identification of the positions of each mixed straddle for which you are electing this treatment (the straddle-by-straddle identification method), or
2) ***Election C.*** Establish a mixed straddle account with respect to a class of activities for which gains and losses will be recognized and offset on a periodic basis.

These two elections are in addition to the mixed straddle election. If you choose to make an election, only one of the three elections can be made. Use Form 6781 to indicate your election choice by checking Box A, B, or C, as applicable.

Straddle-by-straddle identification (Election B). To elect the provisions of the straddle-by-straddle identification provisions, you must clearly identify each position that is part of the identified mixed straddle before the close of the day on which the mixed straddle is established. If you dispose of part of a position in the mixed straddle before the end of the day on which the straddle is established, such identification must be made at or before the time you disposed of the position. You are presumed to have properly identified a mixed straddle if independent verification is used.

The basic tax treatment under this election is determined based upon which side of the straddle produced the total net gain or loss. If the net gain or loss from the straddle is attributable to the section 1256 contracts, gain or loss is treated under normal rules for section 1256 contracts; that is, 60% long-term capital gain or loss and 40% short-term capital gain or loss. Enter the net gain or loss in Part I of Form 6781 and identify the election by checking Box B.

If the net gain or loss is attributable to the non-section 1256 positions, gain or loss is short-term capital gain or loss. Enter the net gain or loss directly on Schedule D and identify the election.

For the specific application of the rules of this election, see Temporary Regulations Section 1.1092(b)–3T.

Example. On April 3, 1990, you entered into a non-section 1256 position and an offsetting section 1256 contract and made a valid election to treat such straddle as an identified mixed straddle. On April 10, 1990, you disposed of the non-section 1256 position at a $600 loss and the section 1256 contract at an $800 gain. Under these circumstances, the $600 loss on the non-section 1256 position will be offset against the $800 gain on the section 1256 contract. The net gain of $200 from the straddle will be treated as 60% long-term capital gain and 40% short-term capital gain because it is attributable to the section 1256 contract.

Mixed straddle account (Election C). A mixed straddle account is an account for determining gains and losses from all positions held as capital assets which you have designated in a class of activities at the time you elected to establish such an account. You must establish a separate mixed straddle account for each separately designated class of activities.

Generally, you must determine gain or loss for each position in a mixed straddle account as of the close of each business day of the tax year. You offset the net section 1256 contracts against the net non-section 1256 positions to determine the "daily account net gain or loss."

If the daily account amount is attributable to non-section 1256 positions, the amount is treated as short-term capital gain or loss. If the daily account amount is attributable to section 1256 contracts, the amount is treated as 60% long-term and 40% short-term capital gain or loss.

On the last business day of the tax year, you determine the "annual account net gain or loss" for each account by netting the daily accounts for each account for the tax year. The "total annual account net gain or loss" is determined by netting the annual account amount for all mixed straddle accounts that you had established.

The net amounts keep their long-term or short-term classification. However, no more than 50% of the total annual net gain for the tax year may be treated as long-term capital gain. The excess gain is treated as short-term capital gain. Also, no more than 40% of the total annual account net loss may be treated as short-term capital loss. The excess loss is treated as long-term capital loss.

The election to establish one or more mixed straddle accounts for each tax year must be made by the due date (without extensions) of your income tax return for the immediately preceding tax year. If you begin trading in a new class of activities during a tax year, you must make the election with regard to the new class of activities by the later of either:

The due date of your return for the immediately preceding tax year (without extensions), or

60 days after you entered into the first mixed straddle in the new class of activities.

You must make the election on Form 6781 by checking Box C. Attach Form 6781 to your income tax return for the immediately preceding tax year, or file it within 60 days, if applicable. In addition, you must attach a statement to Form 6781 specifically designating the class of activities for which a mixed straddle account is established.

For the specific application of the rules of this election and for the rules pertaining to pre-1985 accounts, see Temporary Regulations Section 1.1092(b)–4T.

Interest expense and carrying charges relating to mixed straddle account positions. You cannot deduct interest and carrying charges that are allocable to any positions held in a mixed straddle account. The term "interest" includes any amount paid or incurred in connection with positions in the account used in a short sale.

Any interest and carrying charges in excess of related income must be capitalized. Treat such charges as an adjustment to the annual account net gain or loss and allocate the charges proportionately between the net short-term and the net long-term capital gains or losses.

To find the amount of interest and carrying charges that is not deductible during the tax year and that must be added to the annual account net gain or loss, apply the same rules, described earlier under *Interest expense and carrying charges relating to straddles,* to the positions held in the mixed straddle account.

If you did not make any of these elections, and you have a loss on the section 1256 component, reduce the loss by any unrecognized gain on the non-section 1256 component. You must also reduce the loss from any section 1256 component of a straddle that would be a mixed straddle if the positions had been properly identified as such. Use Part II of Form 6781 to determine these reductions.

Losses on Small Business Stock

You can deduct as an ordinary loss, rather than as a capital loss, a loss on the sale, trade, or worthlessness of small business stock. Gain on small business stock is a capital gain, if the stock is a capital asset in your hands. Do not offset gains against losses that are within the ordinary loss limits, explained below, even if the transactions are in stock of the same company. Report the gain on Schedule D of Form 1040.

If you must figure a net operating loss, any ordinary loss from the sale of small business stock is a business loss.

Section 1244 stock (small business stock) is stock that was issued for money or property (other than stock and securities), in a domestic small business corporation. This corporation must have derived more than 50% of its gross receipts from other than royalties, rents, dividends, interests, annuities, and gains from sales and exchanges of stocks or securities, during its 5 most recent tax years before the loss. If the corporation was in existence more than one year, but less than 5 years, the 50% test applies to the period of the corporation's tax years ending before the loss. If the corporation was in existence less than one year, the 50% test applies to days the corporation was in existence before the day of the loss. However, if the corporation's deductions (other than the net operating loss and dividends received deductions) exceeded its gross income during this period, this 50% test does not apply. However, the corporation must have been largely an operating company in order for ordinary loss treatment to apply.

If the stock was issued on or before July 18, 1984, the stock must have been common stock. If issued after July 18, 1984, the stock may be either common or preferred. If you want more information about the requirements of a corporation to qualify as a small business corporation, or about the specific qualifications of small business stock, refer to Section 1244 of the Internal Revenue Code and its regulations.

Ordinary loss limits. The ordinary loss that you can deduct on this stock is limited to $50,000. On a joint return the limit is $100,000, even if only one spouse has this type of loss. Thus, if your loss is $110,000 and your spouse has no loss, you may deduct $100,000 on a joint return. The excess of $10,000 is a capital loss.

The stock must be issued to the person taking the loss. You must be the original owner of this stock to be allowed ordinary loss treatment. To claim a deductible loss on stock issued to your partnership, you must have been a partner when the stock was issued and have remained so until the time of the loss. You add your distributive share of the partnership loss to any individual loss you may have on the stock before applying the deduction limitation.

If your partnership distributes the stock to you, you may not treat a stock loss as an ordinary loss.

Stock sold through an underwriter is not small business stock unless the underwriter only acted as a selling agent for the corporation.

Stock dividends and reorganizations. A stock dividend on small business stock you receive from the corporation in which you own such stock qualifies as small business stock if the stock you own meets the requirements when the stock dividend is distributed.

If you exchange your small business stock for new stock in the same corporation in a reorganization that qualifies as a recapitalization or that is only a change in identity, form, or place of organization, the new stock is small business stock if the stock you owned met the requirements when the exchange occurred.

If you hold small business stock and other stock in the same corporation, not all of the stock you receive as a stock dividend or in a reorganization will qualify as small business stock. Only that part based on the small business stock you hold will qualify.

Example. Your basis for 100 shares of X common stock is $1,000. These shares qualify as small business stock. If, in a nontaxable stock dividend, you receive 50 more shares of common stock, the basis of which is determined from the 100 shares you own which met the requirements of small business stock when the dividend was distributed, the 50 shares are also small business stock.

If you also own stock in the corporation that is not small business stock when you receive the stock dividend, you must divide the shares you receive as a dividend between the small business stock and the other stock. Only the shares allocated to the former can be small business stock.

Contributed property. To determine the ordinary loss on small business stock you receive in exchange for property, you have to adjust the basis of the stock if:

The adjusted basis (for figuring loss) of the property, immediately before the exchange, was more than its fair market value, and

The basis of the stock is determined by the basis of the property.

Reduce the basis of the stock by the difference between the adjusted basis of the property and its fair market value. You reduce the basis only to figure the ordinary loss. Do not reduce the basis of the stock for any other purpose.

Example. You transfer property with an adjusted basis of $1,000 and a fair market value of $250 to a corporation for its small business stock. When you figure the ordinary loss under these rules, the basis of your stock is its adjusted basis of $250 ($1,000 minus $750) — the total basis of the stock reduced by the excess of the property's adjusted basis over its fair market value. If you later sell the small business stock for $200, you have an ordinary loss of $50 and a capital loss of $750.

Contributions to capital. If the basis of your small business stock has increased, through contributions to capital or otherwise, you must treat this increase as applying to nonqualified stock when you figure an ordinary loss on its sale.

Example. You buy 100 shares of qualifying small business stock for $10,000. You later make a $2,000 contribution to capital that increases the total basis of the 100 shares to $12,000. You then sell the 100 shares for $9,000 and have a loss of $3,000. You can deduct only $2,500 ($10,000/$12,000 of $3,000) as an ordinary loss under these rules. The remaining $500 is a capital loss.

How to report. An ordinary loss on small business stock is reported on line 10, Part II of **Form 4797,** *Sales of Business Property.* However, if you are reporting a loss on an asset used in a passive activity, use **Form 8582,** *Passive Activity Loss Limitations,* to see how much of the loss is allowed on Form 4797.

You must file a statement with your return if you claim an ordinary loss deduction for your small business stock. It should show the address of the corporation that issued the stock to you, how you acquired the stock, and the nature and amount of your payment for it. If you acquired it in a nontaxable transaction and gave something other than money for it, also show the type of property exchanged, its fair market value, and its adjusted basis on the date you transferred it to the corporation.

You must keep records sufficient to distinguish your small business stock from any other stock you own in the corporation.

Losses on Small Business Investment Company Stock

A small business investment company (SBIC) is one that is licensed and operated under the Small Business Investment Act of 1958.

If you are an investor in SBIC stock, you are allowed an ordinary loss (business loss), rather than a capital loss, on losses from the sale or exchange of such stock. You are allowed capital gain on gains from the sale or exchange of such stock.

How to report. You report these losses in Part II of Form 4797. In addition to the information required by the form, you must include the name and address of the company that issued the stock.

If you have a gain on the sale of SBIC stock, report it as a capital gain on Schedule D of Form 1040. Do not offset your gains and losses, even if they are on stock of the same company.

If you close a short sale of SBIC stock with other SBIC stock, that you bought only for that purpose, any loss you have on the sale is a capital loss. See *Short Sales,* earlier, for more information.

Holding Period

If you sold or traded investment property, you must determine whether the gain or loss was a short-term or a long-term capital gain or loss.

Character of gain or loss. It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. The correct classification of your gains and losses is essential to correctly arrive at your net capital gain or loss and to determine the limit on your capital losses. For information about determining whether your gain or loss was an ordinary gain or loss or a capital gain or loss, see the discussion under *Capital or Ordinary Gain or Loss,* earlier. For more information about figuring your capital gain income and determining your allowable capital loss, see *Reporting Capital Gains and Losses on Schedule D,* later.

Long-term or short-term. If you hold investment property ***more than one year,*** your gain or loss is a ***long-term*** capital gain or loss. If you hold the property ***one year or less,*** your gain or loss is a ***short-term*** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

Example. If you buy investment property on February 1, 1990, you start counting on February 2. The 2nd of each following month is the beginning of a new month. If you sell the property on February 1, 1991, your holding period is not more than one year and you will have a short-term capital gain or loss. If you sell it on February 2, 1991, your holding period is more than one year and you will have a long-term capital gain or loss.

Securities traded on an established market. For securities traded on an established securities market, your holding period begins the day after the ***trading date*** you bought the securities, and ends on the trading date you sold them. Ignore the settlement dates for tax purposes.

Example. You are a cash-method, calendar-year taxpayer. You sold stock at a gain on December 28, 1990. According to the rules of the stock exchange, the sale was closed by delivery of the stock 5 trading days after the sale, on January 7, 1991. You received payment of the sales price on that same day. Report your gain on your 1990 return, even though you received the payment in 1991. The gain is long term or short term depending on whether you held the stock more than one year. Your holding period ended on December 28. If you had sold the stock at a loss, you would also report it on your 1990 return.

U.S. Treasury notes and bonds. The holding period of U.S. Treasury notes and bonds sold at auction on the basis of yield starts the day after the Secretary of the Treasury, through news releases, gives notification of acceptance to successful bidders. The holding period of U.S. Treasury notes and bonds sold through an offering on a subscription basis at a specified yield starts the day after the subscription is submitted.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period of the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's basis, your holding period is considered to have started on the same day as the donor's holding period.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property and your basis for it is determined with reference to its fair market value at the date of the decedent's death, or at the alternate valuation date, or as the decedent's adjusted basis (for appreciated property), your gain or loss on any later disposition of such property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year even if you dispose of it within one year after the decedent's death. For more information about determining basis, see *Inherited investment property,* earlier under *Basis Other Than Cost.*

Real property bought. To determine how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it, or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Real property repossessed. If you sell real property but keep a security interest in it, and then later repossess the property under the terms of the sales contract, your holding period for a later sale includes the period you held the property before the original sale and the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

Nontaxable stock dividends. The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a ***spin-off,*** which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Section 1256 contracts. Section 1256 contracts open at the end of the year, or terminated during the year, are treated as 60% long term and 40% short term, regardless of how long the contracts were held.

Option property. Your holding period for property you acquire when you exercise an option begins the day after you exercise the option.

Wash sales. Your holding period for substantially identical stock or securities you acquire in a wash sale includes the period you held the old stock or securities.

Commodity futures. Futures transactions in any commodity subject to the rules of a board of trade or commodity exchange are long term if the contract was held for more than 6 months.

Except for regulated futures contracts subject to section 1256, your holding period for a commodity on which you accept delivery in satisfaction of a commodity futures contract includes your holding period for the futures contract.

Reporting Capital Gains and Losses on Schedule D

You report your capital gains and losses on Schedule D (Form 1040), *Capital Gains and Losses.* You also use this schedule to figure your limit on capital losses and to reconcile your Forms 1099–B for sales of stocks and bonds. Use Schedule D–1 as a continuation schedule to report additional transactions.

Passive activity gains and losses may also have to be reported on **Form 8582.** In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099–B transactions. If you sold property, such as securities, commodities, bonds, etc., through a broker, you should receive Form 1099–B or an equivalent statement from the broker. Use the Form 1099–B or equivalent statement to complete line 1 of Schedule D (Form 1040).

Report the gross proceeds shown in Box 2 of Form 1099–B as the ***gross sales price*** in column (d) of either line 2a or line 9a of Schedule D, as applicable. However, if the broker advises you, in Box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that ***net sales price*** in column (d) of either line 2a or line 9a of Schedule D, as applicable. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e). Be sure to add all sales price entries in column (d) on lines 2a and b and lines 9a and b and enter the totals on lines 2c and 9c. If line 1 differs from the total of lines 2c and 9c, column (d), attach a statement to your return explaining why.

If the Form 1099–B you receive includes amounts derived from the sale or exchange of section 1256 contracts or straddles, or from hedging transactions, see *How to report,* earlier, in the discussion of *Section 1256 Contracts Marked to Market,* for more information about reporting these amounts.

Form 1099–S transactions. If you sold or exchanged one-to-four-family real estate, you should receive Form 1099–S, *Statement for Recipients of Proceeds From Real Estate Transactions,* from the settlement agent. One-to-four-family real estate is a structure designed for the occupancy of up to four families, such as a house, townhouse, duplex, or four-unit apartment building. It can include stock in a cooperative housing corporation.

The gross proceeds from the sale or exchange are shown in Box 2 of Form 1099–S. Follow the Schedule D instructions for reporting these transactions and include them on lines 2a or 9a as appropriate. Also use Form 1099–S to complete line 1 of Schedule D.

If the building sold or exchanged was your principal residence, report the sale on **Form 2119,** *Sale of Your Home.* Do not include the proceeds from this sale on line 1 of Schedule D.

It is unlawful for any real estate reporting person to separately charge you for complying with the real-estate transaction information-reporting requirements.

Other transactions. Enter all sales of stocks, bonds, real estate transactions (other than the sale of your main home), etc., on line 2a or line 9a of Schedule D (Form 1040), as applicable, whether or not you actually received a Form 1099–B or Form 1099–S. Use either line 2d or line 9d of Schedule D, as applicable, to report gains and losses on other transactions.

Section 1256 contracts and straddles. Use Form 6781 to report gains and losses from section 1256 contracts and straddles before entering these amounts on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

Sale expenses. Add to your cost or basis any expense of sale such as broker's fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D (Form 1040), as applicable, unless you reported the net sales price amount in column (d). For more information, see *Expenses of Producing Income,* earlier.

Short-term gains and losses. Gain or loss on the sale or trade of investment property held one year or less is a short-term capital gain or loss. You report it in Part I of Schedule D (Form 1040).

You combine your share of short-term capital gain or loss from partnerships, S corporations, or fiduciaries, and any short-term capital loss carryover, with your other short-term gains and losses to figure your net short-term capital gain or loss on line 8 of Schedule D (Form 1040).

Long-term gains and losses. A gain or loss on the sale or trade of investment property held more than one year is a long-term capital gain or loss. You report it in Part II of Schedule D (Form 1040).

You also report the following in Part II of Schedule D (Form 1040):

1) All capital gain distributions from regulated investment companies (mutual funds) and real estate investment trusts,
2) Your share of long-term capital gain or loss from partnerships, S corporations, and fiduciaries, and
3) Long-term capital loss carryovers.

The result from combining these items with your other long-term gains and losses is your net long-term capital gain or loss (line 17 of Schedule D).

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 8) with your net long-term capital gain or loss (line 17). Enter the result on line 18, Part III of Schedule D. If your losses are more than your gains, see *Capital losses,* next.

Capital losses. If your capital losses are more than your capital gains, you can claim a capital loss deduction. Up to $3,000 of the excess loss is allowed. Your allowable capital loss deduction is the lesser of:

1) $3,000 ($1,500 if you are married and file a separate return), or
2) Your capital loss as shown on line 18 of Schedule D.

Figuring your loss. You can use your net capital loss to reduce your income dollar for dollar, up to the $3,000 limit.

If you have both short-term and long-term items, you figure your capital loss for the year in the following way:

If you had a net ***short-term capital loss*** and a net ***long-term capital gain,*** your short-term capital loss is your net short-term capital loss minus your net long-term capital gain.

If you had a net ***long-term capital loss*** and a net ***short-term capital gain,*** subtract your net short-term capital gain from your net long-term capital loss. This is your long-term capital loss.

Capital loss carryover. If your capital loss is more than the yearly limit on capital loss deductions, you may carry over the unused part to later years until it is completely used up. When you carry over a loss, it remains long term or short term. Thus, a long-term capital loss you carry over from an earlier year will reduce long-term gains of the current year before it reduces short-term gains of the current year.

You can carry over a capital loss that is more than the amount of allowable loss to the next year and treat it as if you had incurred it in that year. When you figure the amount of any capital loss carryover in a later tax year, you must take into account any deductions for capital losses allowed in earlier years.

The amount of your capital loss carryover is the amount of your capital loss that exceeds the lesser of:

1) Your allowable capital loss deduction for the year, or
2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions exceed your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

A decedent's capital loss during his or her last tax year may be deducted only on the final return filed for the decedent. The capital loss limits discussed earlier still apply in this situation.

This loss may not be deducted by the estate or carried over to following years.

When you figure your capital loss carryover, use your short-term losses first, even if you incurred them after a long-term loss. If you have not reached the limit on the capital loss deduction after using the short-term loss, use the long-term losses until you reach the limit.

Example. Bob and Gloria sold securities in 1990. The sales resulted in a capital loss of $7,000. They had no other capital transactions. On their joint 1990 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 − $3,000), can be carried over to 1991.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover to 1991.

Joint and separate returns. If you are married and filing a separate return, your capital loss deduction is limited to $1,500.

If you and your spouse once filed separate returns and are now filing a joint return, you and your spouse must combine your capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover can be deducted only on the return of the spouse who actually had the loss.

Figuring your capital loss carryover. Complete Part IV of Schedule D (Form 1040) to determine the part of your capital loss for 1990 that you can carry over to 1991.

Comprehensive Example

Jane Smith is single and in addition to her regular employment, she has income from some stocks and other securities. For the 1990 tax year, she had the following capital gains and losses, which she reports on Schedule D. Her filled-in Schedule D is shown at the end of this example.

Capital gains and losses—Schedule D. Jane sold stock in two different companies that she held for short term. In June she sold 100 shares of Bates Trucking Co. common stock that she had purchased in May. She had an adjusted basis of $650 in the Bates stock and sold it for $900 for a gain of $250. In June, she sold 25 shares of Alpha Computing preferred stock that she bought in March. She had an adjusted basis in the Alpha stock of $2,500 and she sold this stock for $2,000, for a loss of $500. These short-term transactions are reported in Part I of Schedule D.

During the year, Jane sold securities she had held for long term in two corporations. In February, she sold 60 shares of Car Motor Co. for $2,100. She had inherited the Car stock from her father. Its fair market value at the time of his death was $700, which became her basis. Her gain on the sale, therefore, was $1,400.

Jane had a basis of $34,000 in 500 shares of Weeping Willow Furniture Co. nonconvertible preferred stock that she bought on June 25, 1987. On June 29, 1990, she sold this stock for $4,100. She realized a $29,900 loss on this sale.

The long-term capital transactions are entered in Part II of Schedule D.

During 1990, she had a realized loss from a regulated futures contract of $27,000, and an unrealized marked-to-market gain on open contracts of $53,000 at the end of 1990. She had reported an unrealized marked-to-market loss of $11,000 on her 1989 tax return. She also bought a forward contract in gold on April 4, 1989, for $10,000 and sold the contract on May 10, 1990, for $12,500. She executed the transactions through XYZ Trading Co. and received Forms 1099–B from them. Her filled-in Form 6781 is shown later.

Capital loss carryover—Schedule D. Jane has a capital loss carryover to 1990 of $800, of which $300 is short-term capital loss, and $500 is long-term capital loss.

She kept a copy of her 1989 Form 1040, Schedule D so she could properly report her loss carryover for the 1990 tax year without refiguring it.

Reconciliation of Forms 1099–B. Jane completes line 1 and Part I and Part II of Schedule D (Form 1040) to reconcile the amounts reported on Schedule D from the sales of various stocks with the amounts shown on the Forms 1099–B she received from her stockbroker. For 1990, the total of her stock sales is $21,600. Jane reports this amount on line 1 of Schedule D. The total of column (d) of line 2c and line 9c equals the amount shown on line 1 of Schedule D.

SCHEDULE D
(Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

(And Reconciliation of Forms 1099-B for Bartering Transactions)

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ For more space to list transactions for lines 2a and 9a, get Schedule D-1 (Form 1040).

OMB No. 1545-0074

1990

Attachment Sequence No. **12A**

Name(s) shown on Form 1040: Jane Smith

Your social security number: 458 00 0327

1 Enter the total sales of stocks, bonds, other securities, and real estate transactions reported to you for 1990 on Forms 1099-B and 1099-S (or on substitute statements). If this total is not the same as the total of lines 2c and 9c, column (d), attach a statement explaining the difference. (Do not include on this line amounts from Form 1099-S if you reported them on another form or schedule.) **See Instructions for line 1**	1	21,600

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see Instructions)	(e) Cost or other basis (see Instructions)	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
2a Stocks, Bonds, Other Securities, and Real Estate. Include Form 1099-B and 1099-S Transactions. See Instructions.						
100 shares Bates Trucking Co.	5-11-90	6-29-90	900	650		250
25 shares Alpha Computing Co.	3-9-90	6-29-90	2,000	2,500	500	
Form 6781, Part I						6,000
2b Amounts from Schedule D-1, line 2b (attach Schedule D-1)						
2c Total of All Sales Price Amounts. Add column (d) of lines 2a and 2b ▶ 2c			2,900			
2d Other Transactions (Do NOT include real estate transactions from Forms 1099-S. Report them on line 2a.)						

3 Short-term gain from sale or exchange of your home from Form 2119, line 10 or 14c	3		
4 Short-term gain from installment sales from Form 6252, line 22 or 30	4		
5 Net short-term gain or (loss) from partnerships, S corporations, and fiduciaries	5		
6 Short-term capital loss carryover from 1989 Schedule D, line 29	6	300	
7 Add lines 2a, 2b, 2d, and 3 through 6, in columns (f) and (g)	7	(800)	6,250
8 Net short-term gain or (loss). Combine columns (f) and (g) of line 7		8	5,450

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property	(b) Date acquired	(c) Date sold	(d) Sales price	(e) Cost or other basis	(f) LOSS	(g) GAIN
9a Stocks, Bonds, Other Securities, and Real Estate. Include Form 1099-B and 1099-S Transactions. See Instructions.						
60 shares Car Motor Co.	inherited	2-13-90	2,100	700		1,400
500 shares Weeping Willow Furn. Co.	6-25-87	6-29-90	4,100	34,000	29,900	
Form 6781, Part I						9,000
Gold forward contract	4-4-89	5-10-90	12,500	10,000		2,500
9b Amounts from Schedule D-1, line 9b (attach Schedule D-1)			-0-			
9c Total of All Sales Price Amounts. Add column (d) of lines 9a and 9b ▶ 9c			18,700			
9d Other Transactions (Do NOT include real estate transactions from Forms 1099-S. Report them on line 9a.)						

10 Long-term gain from sale or exchange of your home from Form 2119, line 10 or 14c	10		
11 Long-term gain from installment sales from Form 6252, line 22 or 30	11		
12 Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries	12		
13 Capital gain distributions	13		
14 Gain from Form 4797, line 7 or 9	14		
15 Long-term capital loss carryover from 1989 Schedule D, line 36	15	500	
16 Add lines 9a, 9b, 9d, and 10 through 15, in columns (f) and (g)	16	(30,400)	12,900
17 Net long-term gain or (loss). Combine columns (f) and (g) of line 16		17	(17,500)

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Schedule D (Form 1040) 1990

Name(s) shown on Form 1040. (Do not enter name and social security number if shown on other side.) | Your social security number

Part III Summary of Parts I and II

18	Combine lines 8 and 17, and enter the net gain or (loss) here. If the result is a gain, **stop here** and also enter the gain on Form 1040, line 13	18	(12,050)
19	If line 18 is a (loss), enter here and as a (loss) on Form 1040, line 13, the **smaller** of:		
a	The (loss) on line 18; or		
b	($3,000) or, if married filing a separate return, ($1,500)	19	(3,000)

Note: *When figuring whether line 19a or 19b is* ***smaller****, treat both numbers as if they were positive.*

Go on to Part IV if the loss on line 18 is more than $3,000 ($1,500, if married filing a separate return), OR if taxable income on Form 1040, line 37, is zero.

Part IV Capital Loss Carryovers from 1990 to 1991

Section A.—Carryover Limit

20	Enter taxable income from Form 1040, line 37. **(If Form 1040, line 37 is zero, see Instructions for amount to enter.)**	20	34,580
	Note: *For lines 21 through 36, enter all amounts as positive numbers.*		
21	Enter the loss on line 19	21	3,000
22	Enter the amount on Form 1040, line 36	22	2,000
23	Combine lines 20, 21, and 22. If zero or less, enter -0-	23	39,580
24	**Carryover Limit.** Enter the **smaller** of line 21 or line 23	24	3,000

Section B.—Short-Term Capital Loss Carryover to 1991

(Complete this section only if there is a loss on both line 8 and line 19. Otherwise, go on to Section C.)

25	Enter the loss on line 8			25	
26	Enter the gain, if any, on line 17	26			
27	Enter the amount on line 24	27			
28	Add lines 26 and 27			28	
29	**Short-term capital loss carryover to 1991.** Subtract line 28 from line 25. If zero or less, enter -0-			29	

Section C.—Long-Term Capital Loss Carryover to 1991

(Complete this section only if there is a loss on both line 17 and line 19.)

30	Enter the loss on line 17			30	17,500
31	Enter the gain, if any, on line 8			31	5,450
32	Enter the amount on line 24	32	3,000		
33	Enter the amount, if any, on line 25	33	-0-		
34	Subtract line 33 from line 32. If zero or less, enter -0-			34	3,000
35	Add lines 31 and 34			35	8,450
36	**Long-term capital loss carryover to 1991.** Subtract line 35 from line 30. If zero or less, enter -0-			36	9,050

Part V Election Not to Use the Installment Method (Complete this part only if you elect out of the installment method and report a note or other obligation at less than full face value.)

37 Check here if you elect out of the installment method ▶ ☐

38 Enter the face amount of the note or other obligation ▶

39 Enter the percentage of valuation of the note or other obligation ▶

Part VI Reconciliation of Forms 1099-B for Bartering Transactions

(Complete this part if you received one or more Forms 1099-B or substitute statements reporting bartering income.)

			Amount of bartering income from Form 1099-B or substitute statement reported on form or schedule
40	Form 1040, line 22	40	
41	Schedule C (Form 1040)	41	
42	Schedule D (Form 1040)	42	
43	Schedule E (Form 1040)	43	
44	Schedule F (Form 1040)	44	
45	Other form or schedule (identify) (if nontaxable, indicate reason—attach additional sheets if necessary):	45	
46	Total (add lines 40 through 45)	46	

Note: *The amount on line 46 should be the same as the total bartering income on all Forms 1099-B and substitute statements received for bartering transactions.*

☐ CORRECTED (if checked)

Proceeds From Broker and Barter Exchange Transactions

OMB No. 1545-0715

1990

Statement for Recipients of

PAYER'S name, street address, city, state, and ZIP code
XYZ Trading Company

1a Date of sale

1b CUSIP No.

2 Stocks, bonds, etc. $

Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number: 10-1111111

RECIPIENT'S identification number: 458-00-0327

3 Bartering $

4 **Federal income tax withheld** $

RECIPIENT'S name
Jane Smith

Street address
1257 Daisy Lane

City, state, and ZIP code
Hometown, TX 78799

Account number (optional)

5 Description

Regulated Futures Contracts

6 Profit or (loss) realized in 1990 $ (27,000)

7 Unrealized profit or (loss) on open contracts—12/31/89 $ (11,000)

8 Unrealized profit or (loss) on open contracts—12/31/90 $ 53,000

9 Aggregate profit or (loss) $ 15,000

Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-B**

Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

Proceeds From Broker and Barter Exchange Transactions

OMB No. 1545-0715

1990

Statement for Recipients of

PAYER'S name, street address, city, state, and ZIP code
XYZ Trading Company

1a Date of sale 051090

1b CUSIP No.

2 Stocks, bonds, etc. $ 12,500

Reported to IRS ☐ Gross proceeds ☒ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number: 10-1111111

RECIPIENT'S identification number: 458-00-0327

3 Bartering $

4 **Federal income tax withheld** $

RECIPIENT'S name
Jane Smith

Street address
1257 Daisy Lane

City, state, and ZIP code
Hometown, TX 78799

Account number (optional)

5 Description Gold Forward Contract

Regulated Futures Contracts

6 Profit or (loss) realized in 1990 $

7 Unrealized profit or (loss) on open contracts—12/31/89 $

8 Unrealized profit or (loss) on open contracts—12/31/90 $

9 Aggregate profit or (loss) $

Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-B**

Department of the Treasury - Internal Revenue Service

Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ **See instructions on back.**
▶ **Attach to your tax return.**

OMB No 1545-0644

1990

Attachment Sequence No **82**

Name(s) shown on tax return: Jane Smith

Identifying number: 458-00-0327

A. ☐ Check here if you made the mixed straddle election under section 1256(d) this year or an earlier year
B. ☐ Check here if you made the straddle-by-straddle identification election under section 1092(b)
C. ☐ Check here to make the mixed straddle account election under section 1092(b)
D. ☐ Check here if you elect to carry back a net section 1256 contracts loss

Part I **Section 1256 Contracts Marked to Market**

	a. Identification of account	b. LOSS	c. GAIN
1	Form 1099-B XYZ Trading Co.		15,000
2	Add column b and column c, line 1	( )	15,000
3	Combine columns b and c of line 2 and enter the net gain or (loss)		15,000
4	Form 1099-B adjustments (see instructions, attach schedule)		
5	Combine lines 3 and 4. If a net gain, skip line 6 and enter the gain on line 7.)		15,000
6	If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back		
7	Reduce line 5 by line 6 and enter the difference here. Partnerships and S Corporations see instructions		15,000
8	Multiply line 7 by 40%. Enter as a short-term capital gain or (loss) on Schedule D. Identify as Form 6781, Part I		6,000
9	Multiply line 7 by 60%. Enter as a long-term capital gain or (loss) on Schedule D. Identify as Form 6781, Part I		9,000

Part II **Gains and Losses From Straddles (Attach a separate schedule listing each straddle and its components.)**

Section A.—Losses From Straddles

	a. Description of property	b. Date entered into or acquired	c. Date closed out or sold	d. Gross sales price	e. Cost or other basis plus expense of sale	f. LOSS If column e is more than d enter difference Otherwise, enter zero	g. Unrecognized gain on offsetting positions	h. Recognized loss. If column f is more than g, enter difference Otherwise, enter zero
10								

11a Enter short-term portion of line 10, column h, here and on Schedule D. Identify as Form 6781, Part II ( )
b Enter long-term portion of line 10, column h, here and on Schedule D. Identify as Form 6781, Part II ( )

Section B.—Gains From Straddles

	a. Description of property	b. Date entered into or acquired	c. Date closed out or sold	d. Gross sales price	e. Cost or other basis plus expense of sale	f. GAIN If column d is more than e enter difference. Otherwise enter zero
12						

13a Enter short-term portion of line 12, column f, here and on Schedule D. Identify as Form 6781, Part II
b Enter long-term portion of line 12, column f, here and on Schedule D. Identify as Form 6781, Part II.

Part III **Unrecognized Gains From Positions Held on Last Day of Tax Year (Memo Entry Only—See Instructions)**

	a. Description of property	b. Date acquired	c. Fair market value on last business day of tax year	d. Cost or other basis as adjusted	e. UNRECOGNIZED GAIN If column c is more than d enter difference Otherwise enter zero
14					

Instructions

(Section references are to the Internal Revenue Code unless otherwise noted.)

Paperwork Reduction Act Notice.—We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us this information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	9 hrs., 49 min.
Learning about the law or the form	1 hr., 58 min.
Preparing the form	3 hrs., 8 min.
Copying, assembling, and sending the form to IRS	16 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the IRS and the Office of Management and Budget at the addresses listed in the instructions for the tax return with which this form is filed.

Glossary

The definitions in this glossary are the meanings of the terms as used in this publication. The same term used in another publication may have a slightly different meaning.

Accrual method: The accounting method you use to report your income when you earn it, whether or not you have received it. You deduct your expenses when you become liable for them rather than when you pay them.

At-risk rules: Rules that limit the amount of loss you may deduct to the amount you risk losing in the activity.

Basis: Usually the cost (money and fair market value of other property or services) of property you acquire.

Below-market loan: A demand loan (defined later) on which interest is payable at a rate below the applicable federal rate, or a term loan where the amount loaned exceeds the present value of all payments due under the loan.

Call: An option that entitles the purchaser to buy, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

Cash method: The accounting method you use to report your income in the year in which you actually or constructively receive it. You deduct your expenses, except for certain prepaid interest, in the year you pay them.

Commodities dealer: A person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

Commodity future: A contract for the sale of a commodity at a future date for a fixed price.

Demand loan: A loan payable in full at any time upon demand by the lender.

Dividend: A distribution of money or other property made by a corporation to its shareholders out of its earnings and profits.

Equity option: Any option:

1) To buy or sell stock, or
2) That is valued directly or indirectly by reference to any stock, group of stocks, or stock index.

Extraordinary dividend: Any dividend you receive on stock which equals or exceeds 5% of your adjusted basis in preferred stock (10% in the case of other stock).

Fair market value: The price at which the property would change hands between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts.

Foregone interest: The excess of the amount of interest that would be payable for any period if interest accrued at the applicable federal rate and was payable annually on December 31, over any interest payable on the loan for such period.

Forward contract: An off-exchange-traded contract for a commodity, government security, foreign currency, or other financial instrument at the current or spot price, for delivery and settlement at a specified future date.

Futures contract: An exchange-traded contract to buy or sell a specified commodity or financial instrument at a specified price at a specified future date. See also *Commodity future.*

Hedging transaction: Any transaction entered into in the normal course of your trade or business if:

1) It is primarily to reduce risk of price change or currency fluctuations on property which is held or to be held by you, or
2) It is primarily to reduce risk of interest rate or price changes or currency fluctuations on borrowings made or to be made, or obligations incurred or to be incurred by you,
3) The gain or loss on it is treated as ordinary income or loss, and
4) Before the close of the day on which the transaction was entered into, you clearly identify it as being a hedging transaction.

Interest: Compensation for the use or forbearance of money.

Investment interest: The interest you paid or accrued on money you borrowed that is allocable to property held for investment.

Limited partner: A partner whose participation in partnership activities is restricted, and whose personal liability for partnership debts is limited to the amount of money or other property that he or she contributed or may be required to contribute.

Listed option: Any option which is traded on, or subject to the rules of, a qualified board or exchange.

Marked-to-market rule: The treatment of each section 1256 contract (defined later) held by a taxpayer at the close of the year as if it were sold for its fair market value on the last business day of the year.

Market discount: The excess of the stated redemption price of a bond at maturity over your basis in the bond immediately after you acquire it. Market discount arises when the value of a debt obligation decreases after its issue date.

Market discount bond: Any bond having market discount except:

1) Short-term obligations with fixed maturity dates of up to one year from the date of issue,
2) Tax-exempt obligations,
3) U.S. Savings Bonds, and
4) Certain installment obligations.

Nonequity option: Any listed option, which is not an equity option, such as debt options, commodity futures options, currency options, and broad-based stock index options.

Options dealer: Any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

Original issue discount (OID): The amount by which the stated redemption price at maturity of a long-term debt instrument exceeds its issue price.

Passive activity: An activity involving the conduct of a trade or business in which you do not materially participate. It also includes any rental activity.

Portfolio income: Gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It includes gains from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment.

Premium: The amount by which the purchase price exceeds the stated redemption price of an instrument at maturity.

Private activity bond: A state or local bond issue of which:

1) More than 10% of the proceeds are used by a private business; and
2) More than 10% of the payment of the principal or interest is:
   a) Secured by an interest in property used by a private business, or
   b) Derived from payments for property (or borrowed money) used by a private business.

Put: An option that entitles the purchaser to sell, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

Real estate mortgage investment conduit (REMIC): An entity that is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property, with multiple classes of interests held by investors. These interests may be either regular or residual.

Regulated futures contract: A section 1256 contract that:

1) Provides that amounts that must be deposited to, or may be withdrawn from, your margin account depend on daily market conditions (a system of marking to market), and
2) Is traded on, or subject to, the rules of a qualified board of exchange, such as a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or any board of trade or exchange approved by the Secretary of the Treasury.

Restricted stock: Nontransferable stock that you get from your employer for services you perform that is subject to a substantial risk of forfeiture.

Section 1256 contract is any:

1) Regulated futures contract,
2) Foreign currency contract as defined in the discussion under *Section 1256 Contracts Marked to Market,*
3) Nonequity option, or
4) Dealer equity option.

Short sale: The sale of property that you generally do not own. You borrow the property to deliver to a buyer and, at a later date, you buy substantially identical property and deliver it to the lender.

Straddle: Generally, a set of offsetting positions with respect to personal property.

Wash Sale: A sale of stock or securities at a loss within 30 days before or after you buy or acquire in a fully taxable trade, or acquire a contract or option to buy, substantially identical stock or securities.

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